Interconnected standard setting for corporate reporting

We write in response to your Cogito paper on the future structure of standard-setting. While not representing official positions of our respective institutions, the opinions expressed in this letter capture our own individual wide-ranging research expertise and policy engagement, as is appropriate for the broad topic of non-financial reporting.

We endorse the motivation for the Cogito paper, as stated in the executive summary:

> *Climate change, environmental degradation, human rights, social concerns, and internally generated intangibles are of growing global concern to companies, investors, policymakers, regulators and civil society.*
>
> *There is a need for interconnected standard-setting for corporate reporting to coordinate, rationalise and consolidate ... And create a core set of global metrics. This should also make a connection to financial reporting.*

Our response adopts the criteria applied in the Cogito paper to evaluating alternative approaches. Those nine criteria (1-9 below) are classified under three headings (A-C below), which together summarise the challenge at hand:

- **A.** **Progress**. In the light of the urgency of issues associated with nonfinancial information, which approach achieves the most rapid, achievable path to a global standard-setting solution?
  - **1.** Urgency
  - **2.** Global or local solution
- **B.** **Authority**. A standard setter must have legitimacy, credibility and accountability in order to have generally accepted authority. This requires robust governance and oversight, including due processes that respond effectively to stakeholder interests. Which approach best delivers these attributes?
  - **3.** Oversight
  - **4.** Due process of standard setting
  - **5.** Responding to stakeholder interests
  - **6.** Materiality lens
- **C.** **Standards**. High quality nonfinancial standard setting calls for a conceptually consistent framework, a focus on the development of material metrics, an infrastructure and technology to ensure effective dissemination, and appropriate alignment between financial and non-financial reporting. Which approach best delivers these attributes?
  - **7.** Framework and metrics
  - **8.** Legal embedding
  - **9.** Role of technology

While the Cogito paper offers four alternative approaches, three of these (Approaches 1, 3 and 4) are essentially variations on the theme of IFRS structure, while the fourth (regional consolidation) is substantially different. We therefore first compare the three similar approaches, and then compare the 'best' of these against the fourth approach.

These two analyses are presented in Appendix 1 and in Appendix 2, respectively.

Summary

Our view is that Approach 4 is the strongest of the three IFRS structures. This is primarily because it most effectively enables the expertise and experience required for NFI, while also providing for a coordinated approach to both financial and non-financial corporate reporting.

Approach 2 and Approach 4 differ primarily on issues of globalisation and of materiality, and on the latter issue they are not so much competing alternatives as potential complements.

On globalisation, Approach 2 and Approach 4 both aim, ultimately, for global NFI standards. But while Approach 4 aims for this goal directly, Approach 2 aims instead to build out from a European foundation. The central tension here concerns political control, on the one hand, and the likely attainment of global standards, on the other. Approach 2 would give the EU autonomy over NFI standard-setting, but it would make it difficult for those standards to be accepted globally. Approach 4 would require the EU to cede a degree of control over standard-setting, but there would be a greater chance of achieving global standards.

On materiality, Approach 2 and Approach 4 are competing alternatives only if both adopt the same materiality lens. They are instead potentially complementary if each has a different materiality lens. The central question here is whether one set of mandatory NFI standards can satisfy both investor and stakeholder/social informational needs. If yes, then Approach 4 alone best meets those needs, because investor-oriented corporate reporting, both financial and non-financial, would naturally be an extension of the existing IFRS structure. If no, then Approach 2 is required in addition, as a complement to investor-oriented corporate reporting, with a non-financial materiality lens that is more explicitly social. The difference is that Approach 2 would mandate disclosure that was not informationally useful to investors, but material instead to other stakeholders, or to society at large.

Recommendation

We support **Approach 4**. This is for two reasons:

- First, Approach 4 has much greater potential with respect to global acceptance. It is unrealistic to expect global adoption of an approach that is designed and controlled locally, as is illustrated by the globalisation of IFRS, in contrast with the localisation of US GAAP. This is especially important for NFI because the underlying challenges are global. To cite the most obvious example, climate change is an unavoidably global issue. A local ‘solution’ is not in itself a solution at all, because meeting a policy objective to curb global warming is infeasible in the absence of global cooperation. By creating barriers to global acceptance, Approach 2 risks undermining the EU’s policy ambition in this regard. Conversely, if the EU were to initiate, promote and support Approach 4, and commit to adopting the resulting standards (with appropriate endorsement process), then it would be in a strong position to ensure that the specific implementation of Approach 4 would reflect the EU's views, against criteria such as public accountability and balanced membership of the standard-setting body.

- Second, consideration of materiality leads also to Approach 4. At the minimum, an obvious need is to provide investors with a holistic view of corporate performance, with respect to which financial accounting standards are limited, and NFI standards are currently lacking. Our view is that the greatest weakness in NFI reporting, in this regard, arises from it being voluntary, and thereby lacking informationally useful attributes characteristic of financial reporting, such as completeness and comparability. Increasingly, investors are aware of the risks to their investments from factors such as climate change and natural resource dependency, yet they lack the information with which to make informed decisions. In this context, an investor materiality lens, bringing NFI standards into an information set alongside the financial statements, would be best achieved under Approach 4. In itself, however, this conclusion does not imply that there is not also a (complementary) need for Approach 2, based upon a stakeholder/social materiality lens. On this issue, we note that there is a very high degree of overlap between information viewed through investor and stakeholder/social materiality lenses. To cite again the most obvious example, carbon emissions data would be standardised in much the same way whichever lens they are viewed from; if meeting science-based targets for carbon emissions is essential for stakeholders/society, then the consequences for business model transformation are ultimately inescapable for investors. Moreover, the need to make immediate progress on carbon standards would be achieved much more effectively by having one standard setter, operating through one materiality lens, than by creating a more complicated and ambiguous institutional framework, in which two standard setters overlap and potentially conflict with one another. Consideration of materiality leads us to recommend an exclusive focus on Approach 4.

Overall, our strongly held view is that the implementation of Approach 4 would be the most effective way to achieve NFI standards. While Approach 2 could also be implemented alongside Approach 4, to serve a distinctively different political geography and materiality, such an approach would most likely undermine the effectiveness of Approach 4, and so be undesirable on balance. This is especially the case because the EU's role is absolutely critical to the chances that either approach would have of successful implementation. Approach 4 best aligns with the current policy objectives and political momentum within the EU, in support of the development of NFI standards (see Appendix 3), while also best serving a broader global need, from both investor and social perspectives. The opportunity is best served by an unambiguous EU focus on Approach 4, giving it the greatest chance of success.

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*****The views expressed herein are personal views; they do not represent official positions of the European Accounting Association, the EFRAG Academic Panel, the Corporate Reporting Council, nor those of respective universities.

Appendix 1 - Relative merits of Approaches 1, 3 and 4

A comparison among these three approaches is summarised in the following table, which is discussed below.

	Approach 1	Approach 3	Approach 4
Progress			
1. Urgency	Fastest	Medium	Slowest
2. Global or local solution	Global	Global	Global
Authority			
3. Oversight	Weakest	Strongest	Strongest
4. Due process of standard setting	Weakest	Medium	Strongest
5. Responding to stakeholder interests	Weakest	Medium	Strongest
6. Materiality lens	Weakest	Medium	Strongest
Standards			
7. Framework and metrics	Weakest	Medium	Strongest
8. Legal embedding	Similar	Similar	Similar
9. Role of technology	Similar	Similar	Similar

Progress

Urgency

Organisationally, Approach 1 essentially leaves the IFRS structure in place, and simply expands the responsibility of the trustees to include a new INSB. Approach 3 also does little to change the essential IFRS structure, because both trustees and IASB continue as before, while a parallel, NFI Oversight and INSB structure is put in place. Approach 4 leaves the IASB essentially unchanged, and also introduces the INSB, yet it makes more significant change to the existing IFRS structure at monitoring and oversight levels. It is not immediately obvious which of these changes could be implemented most quickly, but on the assumption that greater change in organisational structure takes longer to implement, the quickest would be Approach 1, and the slowest Approach 4.

Global or local solution

All three approaches are global, and therefore considered equal on this criterion.

Conclusion on Progress

Approach 1 is the strongest against the criterion of progress, though there is little to choose between the different approaches.

Authority

Oversight

The current oversight structure of the IASB is designed for financial reporting, and simply adding the INSB to the responsibilities of current trustees (and monitoring board) is therefore asking the existing structure to do something for which it was not designed. In contrast, Approach 3 creates a new oversight body with unambiguous responsibility for the INSB which, together with a relatively straightforward process for enhancing the monitoring board, would allow a clear and accountable oversight structure. Approach 4 shares some of these beneficial characteristics of Approach 3, and by integrating oversight into a single body, it proposes a structure similar to that which operates effectively in the USA, where the FAF 'sits above' both the FASB and the GASB. While Approaches 3 and 4 are both stronger than Approach 1, neither is obviously preferable to the other. None of these differences is critical, however, in choosing among the approaches, any some additional degree of variation would be possible in each case (Approach 1 need not retain Monitoring Board and Trustees 'as currently constituted', for example, and both could be broadened).

Due process of standard setting

A benefit of the IFRS structure is that comprehensive due process has been developed over a considerable period of time. That benefit applies, to a large degree, to all three approaches. The addition of a distinct competence, with respect to non-financial reporting, does, however, require consideration of two issues, namely credibility in this domain and capacity to generate funds for the INSB to operate independently and with sufficient resources. Approach 1 is not designed with these two issues in mind. Approaches 3 and 4 are similar in this regard. Approach 4 is the stronger, however, because the need for funding can be approached from the combined, stronger base of corporate reporting as a whole, rather than needing to find incremental funding for NFI. As the Cogito paper notes, such funding is essential for there to be independent, inclusive and accountable due process. Approach 4 would also better enable more efficient allocation of resource between the activities of the two boards.

Responding to stakeholder interests

The greater the stakeholder-specific expertise and experience within the organisational structure, the greater the responsiveness to stakeholder interests. Approach 1 is clearly the weakest in this regard, because it makes no accommodation for a stakeholder lens different from that conventionally understood in financial reporting. Approaches 3 and 4 are both stronger in this regard. The trade-off between these approaches is that Approach 3 more obviously maintains a focus on stakeholders in non-financial reporting, while Approach 4 more obviously ensures consistency and coherence, by aligning and reconciling stakeholder interests in both financial and non-financial reporting. In a practical sense, stakeholder engagement takes place overwhelmingly at board level, while the need at oversight level is to ensure such things as appropriate composition of the board, alignment with purpose, and so on. Approach 4 is therefore preferred, because both approaches maintain an appropriate stakeholder focus at board level, while the greater need at oversight level is for consistency and coherence. That said, there is a practical issue here, which the Cogito paper does not address, namely that the current role of the trustees with respect to standard setting is limited to ensuring due process, but not any particular outcomes. The trustees cannot now make the IASB stick to its own Framework, and would therefore, unless their role is changed, have limited ability to ensure consistent outcomes. The preference here for Approach 4 is therefore premised on consistency and coherence being more likely than under Approach 3, even though not guaranteed.

Materiality lens

Non-financial information is increasingly material to investors. Information relating to Natural Capital is increasingly important because the combined challenges of climate change and natural resource dependency are driving disruptive change in business models, and so in the capacity to generate value. Information relating to Human and Social Capital is increasingly important in a variety of ways, not least in greater pressure on corporations with respect to issues ranging from diversity, inclusion and equality, to trust in institutions, health and safety, and the future of work. Again, all of these factors potentially affect the capacity to generate value, and they are therefore increasingly material not just to society as a whole but also to investors specifically. Intellectual Capital, likewise, sits behind dramatic change in the corporate sector's capacity to generate value, while also having social implications ranging from privacy and data security to transformational impact in everyday life. Against this backdrop, the primary standard-setting ambition is to enhance users' understanding of the impact on value creation of financial and non-financial information alike. This requires a different mindset from financial reporting, because corporate performance extends beyond changes in the reporting period to financial capital. It includes the effects of changes in other capitals, which have possible implications *both* for the future progression of financial capital and, more generally, the well-being of society. Enacting this change in mindset is essential, both in escaping the narrow, traditional lens of financial reporting, but also in ensuring that corporate performance can be understood in its entirety, and not with financial performance remaining divorced from non-financial performance. To this end, Approach 1 is poorly suited, because the INSB is simply attached to a structure that otherwise operates within a traditional, financial reporting mindset. Approach 3 risks being dysfunctional, because there is no mechanism for ensuring a coherent understanding of materiality for the corporation. An unhelpful divide is created between financial performance, in one box, and non-financial performance, in another. This is not aligned with the way in which companies function, and therefore with the way in which they need to be understood. Corporate strategy balances, in whatever way directors think best, the interests of different stakeholders, which (while they may conflict) are unavoidably inseparable. Approach 4 is therefore the only structure adapted to this reality.

Conclusion on Authority

Approach 4 is the only approach that combines an appropriate level of non-financial expertise and experience with an overall coherence that treats both financial and non-financial as complementary elements of corporate performance. It follows that Approach 4 would most likely have the greatest credibility with, and responsiveness to, the informational needs of stakeholders. In turn, this gives Approach 4 the strongest platform for effective authority.

Standards

Framework and metrics

There are two issues arising under this heading. The first is which of the approaches would have the most effective conceptual framework, operating as a guide for consistent standard setting, similar to the IASB's existing framework. The second is which approach would have the most effective standards, judged both by agenda management in terms of work priority, and by quality in terms of criteria such as comparability, transparency and auditability. Related to both of these issues - though conceptually separable - is the existence of several existing sources for frameworks and/or standards.

With respect to a framework, Approach 1 could, in principle, extend the existing IFRS framework, though it is not obvious how this would happen; it would be an inappropriate role for trustees, given its technical nature, yet neither would it sit within either IASB or INSB. Approach 3 has the same problem. Approach 4 is the only structure that addresses the problem, albeit that technical ownership remains unclear, and not so different from Approach 3. Approach 4 is preferable to Approach 3, because a single body has oversight of an overall framework, making potential conflict resolution more straightforward.

While it is difficult to separate issues of the framework from those of standard-setting, there is no particular reason to think that the quality of standard-setting would vary across the three approaches. Each approach proposes an INSB. Aside from issues raised elsewhere - for example, oversight and stakeholder responsiveness - the standard-setting body itself is a constant in the three approaches.

With respect to either framework or standards, any of the three approaches could in principle adopt, amend or reject any of the existing sources for frameworks and/or standards. It would, however, be a more productive, and less contentious starting point, to adopt either Approach 3 or Approach 4 in this regard, because both more explicitly recognise the importance of NFI as a distinct area of expertise and experience, and neither appears to presume – as in Approach 1 – that NFI can simply be folded into a financial reporting structure. This lends itself to a more productive relationship with existing bodies in NFI reporting.

Legal embedding

As the experience of IASC/IASB illustrates, legal embedding is essential for there to be widespread and effective adoption of standards. There is little difference among the three approaches in this regard, because each has legal embedding similar to that of the existing IFRS structure.

Role of technology

The Cogito paper considers technology only in the narrow sense of creating a taxonomy, with implications for data and index providers. In this regard, there is little to choose between the three approaches, and each could be equally effective in developing an NFI taxonomy that could be aligned with an IFRS taxonomy.

Conclusion on Standards

Approach 4 is the only approach that combines an appropriate level of non-financial expertise and experience with an overall coherence that treats both financial and non-financial as complementary elements of corporate performance. It follows that Approach 4 would most likely have the greatest credibility with, and responsiveness to, the informational needs of stakeholders. In turn, this gives Approach 4 the strongest platform for effective authority.

Appendix 2 - Comparison of Approaches 2 and 4

A comparison among between Approaches 2 and 4 is summarised in the following table, which is discussed below.

Two general points should be made. The first is that, in contrast with the comparison above between Approaches 1, 3 and 4, there is less of a like-for-like comparison between Approaches 2 and 4. This is because Approach 2 is not presented in the Cogito paper alone, but is instead a summary of a comprehensive, separate report. The second point is that Approaches 2 and 4 are not entirely mutually exclusive. In both cases, for example, the EU is a critically important institution.

	Approach 2	**Approach 4**
Progress		
1. Urgency	Faster	Slower
2. Global or local solution	Weaker	Stronger
Authority		
3. Oversight	Similar	Similar
4. Due process of standard setting	Similar	Similar
5. Responding to stakeholder interests	Similar	Similar
6. Materiality lens	Weaker	Stronger
Standards		
7. Framework and metrics	Similar	Similar
8. Legal embedding	Weaker	Stronger
9. Role of technology	Similar	Similar

Progress

Urgency

There are three factors affecting the speed with which standards can be set. First is the establishment of the standard-setting organisation itself. Second is the process of standard-setting by that organisation. Third is the legislative process by which those standards become mandatory. The first and third of the steps are, to a large degree, one-off, set-up processes, while the second repeats with each standard, and varies with the complexity and contested nature of the standard. While the third step might take considerable time, it is possible that urgent action on the first two steps, taken in a way that enables widespread legitimacy, would anyway lead to considerable early adoption.

With respect to the first factor, it is not immediately obvious which of the two approaches would be the fastest. Approach 2 has the benefit of a narrower jurisdictional frame, whereby consensus is presumably more straightforward to achieve within Europe, than if establishing a standard-setting board acceptable to a global stakeholder base. In contrast, Approach 4 has the benefit of being a relatively small and focused organisation, less constrained by stakeholders unrelated to corporate reporting. There is a trade-off here, in that a longer process would be more transparently and effectively responsive to stakeholder interests, so giving the organisation greater legitimacy: speed on the first of the three factors might not, therefore, correspond to a faster standard-setting process overall. Further analysis is called for here to determine which of the two approaches would establish a legitimate standard-setting body fastest.

Time taken for due process would presumably be longer for Approach 4 than for Approach 2. This is simply because both approaches would need an effective due process within Europe, while Approach 2 would in addition need to be responsive to global stakeholders.

The third step would presumably be much the same between the two approaches, at least in a European context, because both would require European legislation. This need is obvious for Approach 2, but it applies equally to Approach 4. It was European legislation that was the critical, enabling factor in IFRS becoming global, and there was in practice no need to ensure equivalent legislation elsewhere in the world prior to IFRS becoming mandatory in Europe. It is noteworthy that, while the IASC was already an established structure prior to EU adoption, and while each country had its own financial reporting legislation in place, the difference now is that the EU can have a much larger say over the design of the standard setter, along with less change required at the level of national legislation and practice; the path to legislative change should therefore be more straightforward, for both Approach 2 and 4, than was the case for IFRS.

Global or local solution

At first sight, Approach 2 is clearly local, and Approach 4 global. The real difference, however, is in the pathway to becoming global. There is little doubt that the stakeholder demand for NFI is global, especially so in the most critical area of climate change, where a local solution cannot be sufficient.

Approach 2 operates in stages. The first stage is to establish a European model, and the second to globalise that model, through some form of ‘organised cooperation.’ Approach 4 establishes a global model from the start and, just as with IFRS, seeks to secure jurisdictional buy-in. Again, though, these differences can be overstated. In both cases, the most likely path starts with legislative endorsement within Europe.

The question then becomes one of which approach, starting from a European foundation, can most effectively globalise. The most likely answer is Approach 4, because a model (such as Approach 2) that is too closely associated with governmental control in any given jurisdiction, is less likely to be attractive to governments in other jurisdictions. Just as the FASB’s national standard-setting approach was not attractive to the EU at the time of IFRS adoption, so too an EU model is unlikely to be attractive to major jurisdictions internationally. This is especially important for countries such as China, India and the USA, whose buy-in will ultimately be essential in securing effective global NFI reporting. Globalizing from Approach 2 would require a plan to relinquish, or at least share, control over the process, as more countries buy into the standards. There is no such plan articulated by Approach 2, in much the same way that the FASB was never able to position itself as an international standard setter.

In this context, we urge that viewing NFI standards as a source of ‘competitive advantage’, as advocated by Approach 2, is potentially very damaging.[1] The idea here is that Europe ‘wins’ by making its sustainable business models more transparent, and more attractive to investors. The corollary is a relative lack of transparency in the rest of the world. To stylise the implication of this, picture wind farms in Europe, and coal-fired power stations in China, India and the USA; to win in this game would be to lose, because climate change does not respect national boundaries. Moreover, the objective of gaining competitive advantage through stronger NFI reporting is inconsistent with the aim of achieving global NFI standards; both cannot be pursued simultaneously.

Conclusion on Progress

Approach 2 would give the EU more direct control, and so the initial steps towards creating global NFI standards could in principle be taken more quickly. In the ideal world, this would then trigger global change more quickly and effectively, though the political obstacles to global adoption would be considerable. In contrast, Approach 4 potentially faces greater barriers towards initial creation, yet it also offers a 'tried and tested' route to global adoption. It is hard to overstate the importance of globalisation in this context, because planetary boundaries are not regional, and their breach is an acute concern for all, and beyond the individual power of any. Rather than simply concluding that Approach 4 is preferred, however, on the grounds that it offers less friction in global adoption, it is critically important to highlight synergies between the two approaches, and not to view them as mutually exclusive. Approach 2 requires a 'full-on' engagement from the EU, while Approach 4 positions that engagement more at 'arm's-length'. Greatest progress would actually be most likely if the EU mobilised a 'full on' approach in promoting and establishing the standard-setting framework of Approach 4, including an endorsement and adoption mechanism within Europe, similar to that currently applied to IFRS. This would require ceding a degree of control with respect to governance and oversight, in order that the model is acceptable globally, yet it would also require the strongest endorsement and proactively facilitating of the creation of the Approach 4 structure, including legislative backing and the direction of funding that would otherwise have supported a European standard-setting body. Such support could be conditional, as was the case with the creation of the IASB. In other words, NFI standards created by the new body would be enacted in law if, and only if, they passed a specified quality threshold. There would remain a possibility, of course, that these standards were not adopted elsewhere in the world, in which case the outcome would in effect default to Approach 2. By taking the Approach 4 route, however, the possibility of globalisation is made more realistic.

Authority

Oversight

The central difference here between Approach 2 and Approach 4 is the purpose for which the oversight is designed. There are two issues to consider. First is whether oversight should embrace financial reporting, or whether NFI structure can instead be on a standalone basis. Second is which stakeholders the oversight is designed to

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[1] See p7 and p214 in de Cambourg, P. (2019), ‘Ensuring the relevance and reliability of non-financial corporate information: an ambition and a competitive advantage for a sustainable Europe.’

serve. Approach 4 is clearly stronger on the first of these two issues, but the answer on the second issue is less clear. If the aim is for NFI standards that serve European public policy needs, then Approach 2 is clearly stronger. If the aim is for NFI standards that serve global capital market needs, then Approach 4 is clearly stronger. And if the aim is to serve global public policy needs then the solution is less obvious. As these underlying issues are discussed more fully against other criteria, however (under 'global or local solution' and 'materiality lens'), the approaches are ranked equally here.

Due process of standard setting

As discussed above, a benefit of Approach 4 is that a comprehensive due process has been developed within the IFRS structure over a considerable period of time. Yet many of these benefits also hold for Approach 2. For example, part of the due process would be to publish technical materials in all EU languages. This is a capability of the IFRS Foundation but, so too of course, it is a strength of the EU itself, which Approach 2 could rely upon. Funding, likewise, can be viewed as substitutable, because the resource that the EU is able to put into NFI standard setting could, in principle, be applied either to Approach 2 or to Approach 4. Likewise, the EU's legislative capabilities would be needed for either Approach 2 or for Approach 4.

The distinctive difference between the two processes comes down to the purpose of the due process. If, for example, Approach 2 is constructed to serve European economic and political policy objectives, then its due process would differ from a global approach. In contrast, Approach 4, would of necessity would be less sensitive to region-specific policy. This is less an issue of how due process is undertaken, on which there would be little to choose between the two approaches, and more about how the outcome of due process is adjudicated. The trade-off here is between NFI standards that serve: European needs, for which due process is likely to be more controlled and 'deliverable', and where European interests only would be decisive (Approach 2); global needs, for which due process is likely to be more challenging, and where European interests would need to be negotiated (Approach 4). Taking at face the value the stated ambition of both approaches, which is ultimately to achieve global standards, it follows that Approach 4, though more difficult, is necessarily preferred. As this dimension is already captured, however (under 'Progress'), the approaches are ranked equally on due process itself.

Responding to stakeholder interests

There is no obvious reason to think that either approach would be more, or less, responsive to stakeholder interests. The underlying question here is really one of which materiality lens is adopted, and therefore of which stakeholder interests are in practice served. Either approach would, in principle, be equally capable of applying whichever materiality lens it was required to adopt.

Materiality lens

It is important to be clear about materiality.

Consider first financial reporting. An investor materiality lens is necessary, but insufficient, in ensuring high-quality financial reporting. Also required is that reporting standards are mandatory. If they were not, companies would not themselves produce the information that their investors wish to receive. That is the presumption behind the IASB existing in the first place.

Viewed through an investor materiality lens, NFI reporting therefore raises two questions. The first is whether such a lens is appropriate, and the second is what difference it makes to move from the current, voluntary reporting environment, into a mandatory regime.

It is unambiguous in IFRS that the financial statements are prepared primarily for investors, whose concern is with financial capital. Other stakeholders are acknowledged in the framework, but their information needs are in effect deemed to be served by the information provided to investors. While the framework is silent on corporate purpose, it is plausible either that an investor focus is not inconsistent with a different, social focus, or that the information needs of the latter are a subset of the information already provided in financial reporting to investors.

It is increasingly understood, however, that – turning around the IASB Framework's position – it is meeting the information needs of society that has logical priority, and that, by meeting those needs, investors will also have their informational needs met. Most obviously, the transition to a zero-carbon economy is a social imperative. By providing information on corporate carbon emissions, this social priority is acknowledged. But so, too, is the commercial necessity, from a corporate perspective, to achieve the transition, and so information provided through a social lens becomes very obviously information that also serves an investor need to understand economic sustainability of their portfolio companies.

Alternatively, the same point can be made through an investor materiality lens. The question is whether information on environmental and social impact is sufficiently material to investors that their need for information satisfies the information needs of society. For example, in reporting to investors about exposure to climate-related risks and opportunities, is a company in substance also reporting 'to society' about its accountability for the same? If the answer is yes, then the investor materiality lens is sufficient, and the aim of NFI standards is to raise the quality of reporting through that lens. In effect, the conclusion here would be that voluntary NFI reporting is currently insufficient, but that mandatory disclosure would ensure that companies provide the information that their investors (and other stakeholders) are lacking. If, on the other hand, the investor materiality lens is not sufficient, then it becomes necessary to identify two distinct forms of mandatory reporting, one that serves investors, and the other that serves society more broadly. The point is this. Applying an investor materiality lens, there is a need for mandatory NFI reporting, delivered in a coherent way alongside financial reporting. But this form of NFI reporting would be insufficient from a social perspective, such that additional NFI standards would also be required, to meet the informational needs of other stakeholders. It is unrealistic in this case to imagine that the creation of an NFI standard setter would itself 'solve' the problem of NFI reporting, because there would actually be two problems to solve, each with a different solution. There would be a gap in reporting financially-relevant NFI to investors, and an additional gap in reporting incremental, socially-relevant NFI to society.

The flow of this argument points to the following critical question: what are the NFI reporting needs of society that are not informationally relevant to shareholders? This is a surprisingly difficult question to answer. It is hard to think of a corporation being engaged in socially destructive activity, without their investors perceiving this ultimately to be a financial risk. Sure enough, past experience globally is one of very significant environmental and social damage being done by corporations before this begins to be priced into their shares, yet the critical role here for NFI reporting is to enhance information, to influence investors' and managers' perceptions of risk and of requisite business transition, and so to accelerate the internalisation of environmental and social impact .Consider, for example, that if a company has a high carbon footprint, it does not yet bear the full social cost of that activity, but it matters to investors whether and how that company's business model can achieve a commercially viable zero-carbon transition. Viewed in this way, the main problem currently with NFI reporting is not that it serves interests other than those of investors, but instead that it is voluntary and not mandatory. The materiality debate therefore risks being seriously misleading, from a policy perspective. The applicability of an investor materiality lens is not in itself something which separates Approach 2 from Approach 4. If, however, there is argued to be a need for 'public interest' NFI standards, in addition to 'capital market' NFI standards, then the two approaches are best not viewed as alternatives but instead as complements. The division of responsibility between the EU and the IFRS Foundation seems obvious. The former has the governmental role of serving the public interest, the latter has legitimacy in setting investor-oriented standards in capital markets. On this view, both Approach 2 *and* Approach 4 are needed.

Conclusion on Authority

The critical issue here is materiality. To the extent that the materiality lens for NFI standards replicates that for financial reporting, Approach 4 is preferred. This is because the IFRS Foundation already has global authority with respect to financial reporting, and it is thereby best placed to incorporate NFI standards into a coherent overall approach to corporate reporting. If, in addition to this demand for NFI standards, there is also a need to apply a supplementary, stakeholder/social materiality lens, then this would be inconsistent with Approach 4, and a complementary standard-setting regime could be established through Approach 2. While this would be likely to unduly complicate the institutional landscape, and to dissipate funding and focus on time-critical issues, notably climate change, it would be necessary to adopt a two-pronged approach such as this, if two different materiality lenses were deemed to be essential.

Standards

Framework and metrics

As noted earlier, there are two issues here: which of the approaches would have the most effective conceptual framework; and which approach would have the most effective standards, judged both by agenda management in terms of work priority, and by quality in terms of criteria such as comparability, transparency and auditability.

With respect to a framework, Approach 4 is more explicitly connected, organisationally and conceptually, with financial reporting under IFRS. Approach 2, in contrast, has greater flexibility to 'do its own thing', and so the question comes down to which of these two modes of operating is preferable. This, in turn, rests upon consideration of alignment with financial reporting and of materiality. If corporate reporting is viewed holistically, there is little merit in divorcing financial reporting from NFI reporting, and so Approach 4 is preferred. If, however, NFI reporting is motivated by a notion of materiality that differs from financial reporting, then an element of conceptual separation is not only inevitable, but also desirable. These are not questions of the competence of a standard-setting body to develop a framework and metrics, however, but are instead concerned with the criterion of materiality, as discussed above. On the specific question of standard-setting competence, there is no obvious reason to suppose that Approach 2 is better or worse than Approach 4.

As noted earlier, a related issue here is which approach could most constructively work with existing NFI framework or standards, by collaborating, adopting, amending as appropriate. In this regard, both approaches explicitly recognise the importance of NFI as a distinct area of expertise and experience, albeit that differences in materiality lens may make collaboration more or less difficult to achieve.

Legal embedding

Both approaches would require legal embedding within Europe similar to that applied currently to IFRS. To the extent that Approach 4 offers fewer obstacles to legal embedding elsewhere in the world, it is the stronger approach.

Role of technology

There is little to choose here between the two approaches, because each has a ‘self-interest’ in developing an NFI taxonomy that could be aligned with an IFRS taxonomy.

Conclusion on Standards

While there is considerable similarity between the two approaches, Approach 4 offers greater opportunity for legal embedding globally and is therefore preferred.

Appendix 3 – The role of the EU

At several points throughout this letter, the critical importance of the EU is described. The alignment between our analysis and the agenda and work plan of the European Commission is illustrated by the following, which comprises extracts from a speech given by Executive Vice-President Valdis Dombrovskis, on 19 Feb 2020, at the IFRS Foundation conference "Financial reporting: remaining relevant in a changing environment." *(Headings, in italics, are added, and not part of the speech.)*

Urgency of climate change a European priority

- There are two major areas where Europe needs to act urgently. Both have a direct impact on the world of corporate reporting. The first is the fight against climate change. And with it, the importance and necessity of sustainable finance to help turn Europe climate-neutral by 2050.

Deficiency of NFI acknowledged, for investors and for society

- As we know, investors look at corporate reporting for timely, reliable and high-quality information as a primary tool for making informed decisions. The green and digital transformations directly affect what information the public needs from companies, and how companies provide it. Investors now want a much broader range of information so they can assess companies' long-term financial performance and value creation.
- We intend to review the Non-Financial Reporting Directive during 2020.
- The Commission will ask EFRAG to start preparatory work on non-financial reporting standards as quickly as possible.

A need for international collaboration acknowledged

- Other bodies too should be involved in developing EU non-financial reporting standards.
- Companies and investors operate globally. They do not want to deal with a host of incompatible reporting requirements or standards.
- The EU cannot do this alone. Given that today's event is co-organised by the International Financial Reporting Standards Foundation, let me reiterate that. The EU is happy, of course, to take the lead. But: we are also open to working with all organisations that have advanced the cause of sustainability and non-financial reporting. And there is a long list of them – most obviously, the International Accounting Standards Board … I invite all public and private standard-setters from across the world to work together with the EU.
- Here, I would mention the report on non-financial reporting prepared by Patrick de Cambourg … his report has some useful ideas to reflect on.
- Our work to develop non-financial reporting will be open, transparent and inclusive. We also we want to avoid fragmentation of global capital markets.

Overlap between financial and NFI acknowledged

- Let me just add a few words on financial reporting. I welcome the work that EFRAG has already done on long-term investment. I hope that the International Standards Accounting Board will quickly follow up on EFRAG's advice. I also invite both to consider the broader impact of climate change on accounting standards – including, for example, the financial impact of stranded assets.