The Association of Accountants and Financial Professionals in Business

<u>via email</u>
To: info@efrag.org

August 8, 2022

EFRAG
35 Square de Meeûs
B-1000 Brussels

Re: Exposure Drafts, *European Sustainability Reporting Standards*

Dear Advisory Group members:

IMA® (Institute of Management Accountants) writes to share its views on the proposed Set 1 of the European Sustainability Reporting Standards, which is comprised of 13 individual standards (collectively, EDs or Proposals).

IMA is a global association representing about 140,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries, and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. Although we were founded 100 years ago in the United States, our members represent many countries from geographic regions around the globe, including Europe, North America, China, Southeast Asia, India, and the Middle East.

IMA is a member of the International Federation of Accountants (IFAC). IMA was a founding member of the International Integrated Reporting Council (IIRC) and under formal arrangement to work cooperatively with the Sustainability Accounting Standards Board (SASB) prior to their reorganization, ultimately into the IFRS Foundation. IMA is also a founding member of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which delivers generally accepted frameworks and guidelines for internal control and enterprise risk management.

IMA is uniquely qualified to provide careful and reasoned insight into the EDs. First, IMA's Financial Reporting Committee (FRC) represents highly experienced financial reporting professionals, including senior-level accounting officers from some of the largest companies in the world. The FRC also includes representatives from each of the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC, as a group, has significant and recognized expertise in reviewing and responding to proposed regulations, standards, and research projects in financial reporting. Importantly, the FRC generally provides preparers' perspectives, and these preparers are the corporate professionals who will be primarily responsible for implementing all newly mandated sustainability standards and connecting reported sustainability information to financial statements issued in accordance with applicable securities law and authoritative generally accepted accounting standards.

Last year, IMA founded its Sustainable Business Management Global Task Force (IMA.SBM.GTF). The task force includes current and former organizational leaders from the IMA Global Board of Directors along with a broad representation of our membership, including university professors, practitioners, and young professionals. Representing a truly global perspective, this group currently has six members from European Union countries along with members from the Middle East, India, North and Central America, China, and Japan. In September 2021, the IMA.SBM.GTF issued a Statement of Position (IMA-SoP) containing nine fundamental principles that we believe must be incorporated into any newly issued sustainability reporting standards. It is our observation that many of the proposed reporting requirements have been issued in a hurried manner with inadequate consideration of a number of key components, as we address in the IMA-SoP. These principles are the guidepost with which we, as an organization, assess new accounting and reporting requirements around sustainability.

Trust

As we emphasize in our SoP Principle 1, trust, accountability, and transparency are the cornerstones of professional accountancy. Our work must build the public's trust. Expectations are for businesses to deliver on sustainability reporting with the same rigor, thoughtfulness, and energy used to deliver on mainstream financial reporting. Sustainability information must be high-quality and reliable; it must be produced through standards and processes that instill this trust.

Mindful that stakeholders are seeking an accelerated timeline, we nevertheless urge the European Commission and the European Financial Reporting Advisory Group (EFRAG) to move with care in issuing standards that meet this expectation and continue to build trust in our profession.

The unprecedented acceleration to produce 13 standards as Set 1, with an expectation of much more to follow, does not allow for an adequate due diligence process or the gathering of adequate data for delivering high-quality standards. Set 1 provides stakeholders little more than three months to respond to these drafts, many of which contain novel and untested approaches to corporate reporting. Comprehensive standards issued without adequate contemplation by stakeholders fails to engender this trust and endangers the reputation of global standard setters.

Core priority: stranded assets

A primary impetus for moving sustainability accounting and reporting from a voluntary activity to a mandatory system, overseen by government regulation, is the grave need for financial information regarding potentially impaired assets and operations due to the global transition from fossil fuel-dependent assets and operations to renewable and other sources of energy that produce low and zero emissions. These potential losses to existing investment in these assets and operations are commonly referred to as "stranded assets."

The phrase "stranded assets" was introduced by the Carbon Tracker Initiative and spearheaded by Smith School of Enterprise and the Environment at the University of Oxford. It is generally defined as "assets that have suffered from unanticipated or premature write-downs, devaluations, or conversion to liabilities." With respect to climate-related energy transitions, stranded assets, globally, are estimated to be in the trillions, and the potential impairment affects all sectors and industries. At some point, fossil fuel-dependent assets will become unrecoverable and worthless. Governments and markets want information about the amount and timing of these pending impairments so they can predict, plan, and support a smooth and beneficial transition to more sustainable investments.

Much of this information, however, is already subject to existing disclosure regulation or financial reporting standards. However, as a practical matter, a wide range of financial statement users—from central banks and asset managers to small businesses and individual pensioners—are not getting the information necessary to support decision making. These rules and their enforcement are already in the hands of European regulatory and standard-setting authorities. To the extent the current systems are not delivering this decision-useful information, it would bring enormous benefit to prioritize and target information regarding stranded asset risk directly.

That is, rather than immediately introduce broad-sweeping and vague reporting standards that attempt to cover *everything*, the European Commission (EC) / EFRAG would well serve economic participants and community stakeholders by strengthening the rules and oversight on the reporting of stranded assets.

<u>Accounting and reporting must be decision-useful</u>

From our members' observations, we understand that passionate advocates for the exposed, voluminous reporting standards are seeking more than corporate reporting of information. Instead, it appears that some advocates are aiming to drive corporate action by driving accounting and reporting. We are aware that there is a common adage, "What gets measured gets managed." However, this catchphrase ignores the reality: Too much measurement leaves few if any resources for insightful and value-added management. That is, if an accounting team is spending substantially all of its resources on external compliance reporting, it will lack the time and resources to partner with management to plan and deliver on sustainable initiatives and projects.

As we note in the IMA-SoP, accounting resources themselves are limited and precious and must be used sustainably. Not all corporate behavior is driven by accounting. Accounting should not be the primary means for driving corporate behavior.

The ultimate intended user of the EFRAG voluminous mandates remains unclear. If the intended users are debt and equity investors in the conventional sense, then we urge more cohesion and cooperation with the International Financial Reporting Standards (IFRS) Foundation's International Sustainability Standards Board (ISSB), which has proven experience in standard setting for these users. On the other hand, if the users are policy makers on behalf of citizens, taxpayers, and members of the community, we observe that the European Commission, as a government body with regulatory authority, has more direct, effective, and meaningful tools to promote less wasteful, long-term preservation and use of common resources within its jurisdiction. It also has means for developing public-private coordination to bring about desired results.

Regulatory bodies can readily require corporate entities to submit, directly, information about the use of resources. To the extent that accounting and reporting on the use of common resources is necessary to carry out the European Commission's governmental regulatory role, we urge specificity and usefulness in mandating the reporting of specific information. Yes, sustainability metrics on the environment, human resources, and governance practices can be useful for policy-maker decisions, but it must be the right metrics and indicators. Volumes of information does not necessarily mean more useful information.

Global alignment, authoritative vs. nonauthoritative guidance

IMA strongly encourages the European Commission and EFRAG to work with other regulators and standard setters to consider the reporting responsibilities of corporate reporting teams in responding to the variety of new mandates around sustainability and climate accounting and disclosures. IMA observes that fragmentation has generally been detrimental to the development, implementation, and usefulness of reported sustainable business information (IMA-SoP Principle 7). Concurrently with the release of the EDs, the U.S. Securities & Exchange Commission (SEC) has released proposed rules on climate risk, and the IFRS Foundation, through the establishment of the ISSB, is proposing new disclosure standards with the ultimate goal of harmonization with existing authoritative guidance under IFRS.

Collaboration and harmonization are essential not only for corporate entities to comply through the delivery of meaningful information, but also for building reporting systems that engender trust. Yet, we are observing that despite calls for working together due to the urgency of the underlying issues, this is not happening meaningfully. Instead of building a workable and aligned accounting and reporting system, well-meaning and passionate advocates are prioritizing personalized agendas in a way that is detracting from the building of the robust systems that deliver the needed information.

Sustainability is more than a question of external accounting and reporting

Critically, our task force members observe that building sustainable businesses and economies cannot rely on external reporting alone. Accounting resources are limited, and accounting itself must be sustainable. That is, we believe that meaningful change will require accounting and finance information to be *actionable* by management (IMA-SoP Principle 3).

We do not want to see the building of sustainable businesses become primarily a compliance exercise but rather a means to build sustainable businesses. Producing high-quality information is a costly process. Therefore, the results of this process must be useful for decision making, or it is unsustainably wasteful. We emphasize that external reporting is only a small part of the overall transition that is needed for the business community to act responsibly.

Relevance to SMEs

Among IMA's membership is a large constituency of CFOs and controllers at small and medium-size entities (SMEs). We observe that the foundational work of creating sustainability reporting standards has been largely voluntary and experimental. So far, only the largest global organizations with resources to innovate and experiment around sustainability reporting have participated. The SME community, however, has been largely absent from the building of these voluntary standards.

Many of our SME constituents feel completely left out of the developments in reporting for sustainability, and they view implementation of new reporting mandates as bewildering and costly. With respect to sustainability, many small business professionals are telling us that they lack both understanding and requisite tools, such as benchmarking data, systems, and personnel.

We note that the EDs make reporting entities responsible for obtaining information from third parties, such as suppliers and customers. Our research shows that the adoption and implementation of sustainability standards as articulated in these EDs will require SMEs to deliver sustainability data to their stakeholders (but not necessarily to the securities markets). The practicalities of this data delivery process and the potential unspecified burdens on SMEs appear to be absent from consideration in the EDs. Moreover, this data sharing along the value chain raises significant concerns around data quality and internal controls, which represents additional, unaddressed challenges.

Clarity with respect to materiality

We observe that the most prominent debate around the EFRAG approach is the concept of impact accounting, to which the EDs refer as "double materiality." We believe that this debate is a misinterpretation and misunderstanding of two corporate reporting concepts as addressed below.

First is the concept of the user. As noted previously, we agree that policy makers and other noninvestor stakeholders have needs for information from corporate entities.

Second, we also observe that the phrase "double materiality" aims to reflect the resources contributed and controlled by an entity that have been contributed by a range of stakeholders, including customers, employees, vendors, and the commons, which include members of the community, taxpayers, and natural resources.

We understand that there are passionate advocates for impact accounting to reflect externalities, sometimes referred to as "impacts and dependencies." In this respect, we find the concepts that underlie impact accounting as reflected in the EDs remain too vague and too challenging to reconcile with IFRS and U.S. Generally Accepted Accounting Principles (U.S. GAAP). The hurriedly developed double materiality concept unnecessarily creates confusion and adds complexities to the goal of connectivity (see IMA-SoP Principle 9). Instead of clarifying how this connects to the basic financial statements and accepted structures of financial reporting, it leaves this unexplained, heavy lifting to preparers to interpret. While we observe that large and well-funded organizations have engaged in the experimentation to report under vaguely written standards, this needs to be considered in building system-wide guidance for sustainability reporting.

Rather than speak of impacts and dependencies, an elegant solution supported by certain members of the IMA.SBM.GTF force is to consider, conceptually, a "hidden balance sheet," which considers this unrecognized value as resources (assets) provided to the entity from multiple external stakeholders (resource providers), such as employees, vendors, customers, and governments (representing the community, taxpayers, and natural resources). These resource contributors allow the entity to *commingle* these assets in its operations with an expectation that the entity will use these resources wisely and not wastefully to generate benefits. In this way, the existing concepts around the basic financial statements and supplemental information can be preserved while also reflecting the resources contributed by all stakeholders. In this way, these external stakeholders are considered "investors" but with different expectations than conventional debt and equity investors.

As noted previously, governmental authorities already have the power and a tremendous range of tools to demand the reporting of requisite information and protect corporate use of common resources without the sweeping changes in the proposed accounting mandates.

Reference to impact accounting by use of the term "double materiality." We strongly encourage the standard setters to use the term "impact accounting" rather than the confusing terminology "double materiality." While the notion of double materiality has been established in European literature for the accounting profession and others outside of Europe, the term needs to be reconciled with conventional concepts and financial market regulations. This use of the word "materiality" rather than "impact accounting" hinders rather than helps Europe communicate with global counterparts. Moreover and as noted previously, this suggested rephrasing would not change types of information that an entity gathers for disclosure, but it would identify the specified user for reported information.

Delivering reliable information on expectations and estimates: A disproportionately large amount of the required information under the proposed mandates is based on expectations of the future and timing and measurement of ultimate realization is speculative. This is predicated on subjective judgment and multiple factors outside an entity's control. The mandates also seem to require disclosure of an entity's assessments of preliminary options and alternatives, even if the entity rejects them. This is inoperable and may very well lead to disclosures that are confusing, too speculative, and ultimately prove incorrect and unreliable.

Materiality, assessment of future conditions: A key operational difference between estimation under mainstream financial accounting and sustainability accounting is time horizon; sustainability reporting incorporates long-term perspective that considers an entity's expected use of available resources and how it will satisfy the expectations of resource contributors. This necessarily requires preparers to gather data and develop additional assumptions for a longer term. This estimation necessarily becomes more qualitative, subjective, and variable for changing conditions. However, the nature of a reporting entity's estimation process may not be different.

Operationalizing double materiality: Because impact accounting is a nascent developing area, an individual entity's "impact" on the totality of a resource depends on whether the totality can be measured reasonably. For example, in the U.S., corporate entities generally are able to deliver information on diversity that reflects an external, impact perspective because governmental agencies produce population statistics on which a corporate reporting entity's reliance is eminently reasonable. However, to report reliably on the "impact" of an individual entity's greenhouse gas emissions or water on the totality of a common resource, agreed-upon measurements of this aggregate total (that is, the denominator) is necessary.

We absolutely agree that the results of impact accounting (our preferred terminology over the confusing term "double materiality") is critically important, and we support the evolution and development of concepts and methodologies. We also observe, however, that the discipline of impact accounting is nascent and therefore, rightfully, less well-defined. The adaptation of the entity concept and the measurement of impacts is still evolving, and there are a variety of approaches. Evolution and testing are necessary. It is important during the current phase of innovation and development to avoid mandating standards that are based on presumptions of precision that are not yet evident as widespread practices. Much more needs to be done in finding solutions and building consensus. We strongly suggest that EFRAG consider the work of academics, thought leaders, and advocacy groups to develop a common measurement baseline and work out the practicalities of entity boundaries and the measurement and characterization of impacts.

Systems, governance, and internal control considerations

As noted, IMA is a member of COSO, which supports the utilization of rigorous and effective control and oversight systems that are requisite ingredients for producing information that is trustworthy and reliable (IMA-SoP Principle 3). Robust internal control systems promote effective decision making and system-wide efficiency. Beneficial decisions regarding the use of common resources depends on high-quality information.

To promote the disclosure of high-quality, reliable information in accordance with the value of trust—the hallmark of our profession—new climate change and other sustainable business disclosures that are not currently part of corporate reporting will require new systems of oversight. New regulations and standards must take into account the development of internal control processes. Our constituents, experts in implementing new types of disclosure in a way that ensures quality and integrity, urge authorities to move ahead with care. Financial reporting professionals must be allowed the time and space to develop and implement effective systems to ensure the quality of material environmental, social, and governance disclosures. In addition, much of the information required to comply is currently outside of companies' accounting systems and processes. Delivering the mandated information will require cross-collaboration, such as with purchases, operations, and human resources.

Many of the proposed mandates, hurriedly drafted, fail to consider both operability and internal control adequately. Even the most well-meaning reporting entity with robust budgets for accounting and reporting may find compliance a practical impossibility because the mandates fail to allow for the development of robust systems of data collection, analysis, summarization, and oversight. In fact, mandates that are not achievable do not build confidence in our legal and regulatory system. They must be workable.

Technology

First, in aiming to minimize fragmentation, we encourage working with regulators and other standard setters on the global stage to issue standards that are interoperable. As noted previously, in building sustainable businesses and economies, use of accounting resources must be sustainable. In 2018, for example, IFAC estimated that fragmented accounting regulations cost the financial sector alone $780 billion annually. There are enormous gains for the profession to produce interoperable reporting standards, and we can demonstrate sustainability by not wasting resources at the individual entity level and system-wide.

Second, when drafting and exposing standards, it is important to consider not only how professional humans will interpret the language but also how it will be translated into machine language. As we noted herein, some of the phrasing in the reporting standards in the EDs is vague. The lack of precision may be acceptable if sustainability standards are voluntary. When moving to issue them authoritatively, precision and the use of technology must be considered so that preparers' systems can deliver responsive data (and auditors can provide attestation). Our FRC preparers, for example, noted the significant and costly challenges of implementing new financial reporting standards (such as leases) when software providers were not ready to provide effective and functional solutions on time.

<u>Conclusion</u>

The European Commission as supported by EFRAG along with other authorities around the world are advancing new precedents, regulations, and standards, simultaneously, that will have significant effects on our profession. Done properly and thoughtfully, they can foster necessary change. Accounting and reporting have a critical role to play in the building of a sustainable future, and contemplated changes will have profound effects on the accounting and reporting ecosystem.

Our constituents, broadly, are critical contributors to driving and supporting change that is effective and brings about actual results, and it is imprudent to dismiss the accounting profession's 700 years of evolution and development that supports our modern economic systems. Global trends and conditions call precisely for the talents and expertise of our members, corporate professionals with important responsibilities for meeting these evolving demands in a way that builds value for all stakeholders and promotes trust.

We urge the Advisory Group to leverage the great potential of thoughtful standards that can be operationalized meaningfully to achieve our common sustainability goals.

Very truly yours,

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