Response to the FRC's *The Future of Corporate Reporting* discussion paper of October 2020

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Carien van Mourik (The Open University) and Chris Humphrey (University of Manchester)

This response to the FRC's discussion paper (DP) stems from our involvement with the Public Interest Statement recommendations for public interest entities (PIEs) in the 2019 Brydon report on the quality and effectiveness of audit.

1. General comments and our recommendation

We welcome the FRC DP's aim of developing a new framework for corporate reporting by PIE's and other reporting entities that accommodates the interests of a wider group of stakeholders than shareholders and investors, includes multiple reports and puts non-financial reporting on a par with financial reporting (FRC DP, p. 10, §2.1). Our main general comments are as follows.

Regarding why PIEs have a responsibility to the general public interest

The FRC DP does not ask or answer questions about what the general public in the UK wants and expects in terms of economic and social role and contribution of capital markets, PIEs and corporate reporting. The assumption appears to be that the purpose of PIEs is value creation, however, the question of 'value to whom' is not explicitly addressed. Why is a PIE of interest to the general public? Because, in addition to creating value for its shareholders and other financial stakeholders, PIEs also have the potential to create significant social and environmental costs and add broader social and economic benefits.

In this sense, PIE external reporting should not only be about reporting to shareholders, investors and other stakeholders, including the general public. PIE external reporting should also be about ensuring that the senior management be mindful and well informed of third-party effects inherent in its business model and consequences of the PIE's activities for the general public.

Regarding stakeholder-neutrality of the Business Report

Calling the Business Report as set out on p. 14 of the DP 'stakeholder-neutral' is misleading. Firstly, because neutrality as to stakeholders' information needs does not necessarily equal neutrality as to trading off their conflicting interests. Secondly, because the proposal is based on the idea that providing products and services, providing jobs and paying taxes are a **by-product of the process of generating and preserving value** (FRC DP, p. 14, §3.11). Whose value? Providing products and services and using employees to do so are not a by-product of a value-generation process. They are part of the very business model of any business, whether they be PIE, private limited company or sole trader.

In truth, the vision of the Business Report set out in §3.7- §3.11 appears primarily focused on the financial interests of investors in equity and debt securities. Does the FRC mean that the public interest that PIEs are meant to serve is, by definition, a by-product of the process of generating shareholder value?

Regarding the Public Interest Statement in the Brydon Report

We believe that the Business Report should include the Public Interest Statement recommended by the Brydon Report and proposed and described by us in Appendix 7 to the Brydon Report (Brydon, 2019, p. 126-132). We suggested that the directors of PIEs issue a Public Interest Statement that sets out 'how they view the company's legal, financial, social and environmental responsibilities to the public interest' (p. 127). The Business Report's discussion of how the business model creates and sustains value must be complemented by the Public Interest Statement. The Public Interest Statement provides an explanation of how the PIE's very business model creates third-party effects (particularly negative externalities) and how the senior management makes trade-offs between different stakeholders including the general public. The PIE's strategy, as set out in its Business Report, would have to be consistent with its self-defined public interest commitments in the Public Interest Statement.

The Public Interest Statement is different from 'The impact of a company's activities on stakeholders and the environment' or 'A company's culture and values statement' mentioned in §5.8 on p. 21 of the FRC DP. Unlike those items, the Public Interest Statement makes explicit how the directors view, and attempt to reconcile, the conflicts between the private interests of shareholders and other stakeholders and the interests of the general public or third parties. As such, the Public Interest Statement provides recognition of the conflicts of interest that are inherent in any business model. It also provides accountability for how the directors have made trade-offs between, or tried to reconcile, stakeholders' and/or the general public's conflicting interests.

Of critical significance in our proposal is the deliberate absence of any detailed specification of a list of key performance indicators through which to assess the meaning of satisfying public interest obligations. The directors of each PIE must determine what they are willing to commit to (and be judged on by the entity's stakeholders, including the general public) with respect to the coherence, veracity and overall credibility of their public interest statement. They would also then be required to 'explain how the PIE has discharged its self-declared public interest obligations and responsibilities, what actions the PIE has undertaken to mitigate any externalities it has caused during the period, and how effective these actions have been' (Brydon, 2019, p. 127).

A PIE's Public Interest Statement should be audited by an external auditor. The Audit Opinion should include a statement on the extent to which the auditor thinks that the content of the Public Interest Statement is true, honest and fair. This assessment should be based on the audit having yielded sufficient evidence of consistency between the content of the Public Interest Statement on the one hand, and the business model, the effectiveness of the internal controls, the company's ethical infrastructure, the financial statements and relevant information in the company's sustainability report on the other hand.

Regarding the Public Interest Report

The FRC DP represents the 'Public Interest Report focused on how the business interacts with the ecosystem in which it sits' as a broader report than the Public Interest Statement recommended by the Brydon Report 'akin to the current sustainability report but with a greater degree of rigour' (FRC DP, p. 26, §6.13). We believe that the 'Public Interest Report' proposed in the FRC DP is basically a sustainability report, the essence of which is rather different from the Public Interest Statement that we suggested. In our opinion, the FRC DP's Public Interest Report is unlikely to improve upon sustainability reporting. Nor does it fulfil the function of the Public Interest Statement outlined above.

With evident on-going international initiatives around the subject of sustainability accounting standards, and the increasing attention being paid to ESG issues by leading investment houses, there has to be a risk that sustainability reporting processes will either by captured by dominant private interests or largely shaped by international standard setting agencies, constraining, in the process, the regulatory authority of domestic regulatory bodies, such as the FRC. As such, we believe that for the FRC essentially to confluence public interest and sustainability reporting would be a mistake and certainly reduce the future forcefulness of the FRC's public interest mission in seeking to enhance the social functionality of UK-based PIEs. Combining a Public Interest Statement with the Business Report and visibly distinguishing public interest reporting from, what in the future could become an increasingly routinised and formulaic, sustainability reporting could be said to be both intellectually more persuasive and institutionally/strategically more astute.

Our recommendation: a combined Public Interest Statement and Business Report

Accordingly, we recommend the adoption, for PIEs, of a combined "Public Interest Statement and Business Report", to be accompanied by the PIE's financial statements and its sustainability report. We believe this approach and combination of reports gives a more appropriate level of primacy and centrality to the public interest status and obligations of PIEs than the proposed network of reports in the FRC's DP. We very much welcome the attempt by the DP to promote public interest reporting and accountability. For the reasons outlined above, we believe that our recommendation is more likely to contribute to delivering on such intentions.

2. What are the key practical challenges and costs and benefits of the proposal?

The FRC's mission statement declares that its purpose is 'to serve the public interest by setting high standards of corporate governance, reporting and audit and by holding to account those responsible for delivering them' (https://www.frc.org.uk/frc-for-you/frc-mission). Promoting a greater public interest orientation in corporate reporting is a challenge that requires more focus on the nature of corporate obligations, commitments, ethical values, and accountability - and less on costs and benefits.

Public interested corporate reporting is something that a public interested body such as the FRC should, by definition, be advocating and enabling. In that sense, the underlying spirit of reform on which the FRC's DP is constructed was already present in the famous 1975 Corporate Report discussion paper published by the ICAEW. It has been more than 45 years since the publication of this document and yet we are still debating the very same principles.

The Corporate Report discussed the public reporting responsibilities of organisations whose activities have significant economic and social implications and consequences. It stated that such reporting had to be useful and defined users as those having a reasonable right to information concerning the reporting entity. It saw such rights as 'arising from the public accountability of the entity, whether or not supported by legally enforceable powers to demand information. A reasonable right to information exists where the activities of an organisation impinge or may impinge on the interest of a user group' (p. 17). It did recognise certain constraints on the provision of such information, including practical issues of cost and confidentiality but stressed the overall commitment of seeking to serve the general public interest.

3. Should corporate reporting focus on a wider group of stakeholders through multiple objective-driven reports instead of a primary focus on investors, lenders and creditors?

All PIE external reporting, financial, governance, social responsibility, sustainability or otherwise, should be general-purpose reporting because all of the reporting entity's reports should draw on one underlying dataset and should, at least in principle, be reconcilable. Different stakeholders have both shared and conflicting interests in the reporting entity. Stakeholders need to know the different ways in which the reporting entity's senior management has traded off all their conflicting economic, financial, social and ecological interests. This will enable them to determine the appropriateness of any such decisions, actions and requisite responses.

As we have made clear in our response to question 2 above, the public interest responsibilities of the FRC are critical here. Historically, the FASB, the IASB and its predecessor body, the IASC, have taken a residual equity view (which is the capital markets version of the proprietary perspective) of the objective of general-purpose financial reporting. For the IASB, this is because it has defined its fundamental reason for being as to foster the development and integration of international capital markets, and it needed to get the SEC behind them. For the FRC, its mandate and vision are more expansive and go beyond the interests and functioning of markets.

4. Would the set of principles outlined in Section 2 of the Discussion paper be helpful in improving the quality of corporate reporting today and into the future?

The FRC's conclusion that the information needs of different user groups are not exclusive, and in many cases significantly overlap (FRC DP, p. 10, §2.3) forms the basis for an objective-driven rather than a user needs driven approach to corporate reporting. We acknowledge that if user groups are deemed to have a similar range of multiple interests then it is possible to say that reporting designed to suit this 'range of multiple interests' is not privileging one user group over another (as all user groups are being treated or classified as having a similar range of multiple interests).

However, we do not believe that the Business Report and its accompanying system of corporate reporting could claim to be stakeholder-neutral if the public interest entities (PIEs) themselves determine their key stakeholders (FRC DP, p. 7, §1.7) by whom they are willing to be held accountable (FRC DP, p. 7, §1.5). It also raises questions as to what 'public interest' means in terms of PIE's if the 'public' is assigned such a passive role and status?

To avoid any practical default to serving the needs of a singular, primary stakeholder, the FRC and the DP ought to be much clearer about the overall societal purpose of PIEs and corporate reporting by PIEs. We would like to see the FRC DP's commitment to 'objective driven' reporting by PIEs (in Figure 2 of the DP – p. 10) more explicitly stating that the overriding PIE reporting objective is one of serving the public interest as set out in the PIEs' public interest statements. Corporate reporting must be transparent about the practical consequences of choosing to privilege certain stakeholder interests over others, and provide accountability for any third-party effects that are generated in the process of trading-off different interests and for how the directors have tried to minimise such externalities.

5. Would more concise reports distributed across a reporting network improve the relevance and accessibility of information?

Not necessarily. Only if the reports are consistent with each other and can be mutually reconciled. Otherwise the information in the reporting network becomes disjointed and the audit trail hard to follow.

Much depends here on the capacity of reports, whether long or more concise, to articulate precisely and with informed authority on matters deemed to be of critical relevance. Concise but misleading reports are clearly not in the general public or any user's interest. A multiplicity of shorter and more frequent reports could be beneficial, but they could also be a source of confusion and uncertainty. It is not possible to say anything definitive here without knowledge of the content of such reports.

A reporting network does not only depend on the reports being produced and published but also on to whom they are directed, and the use made of them. Stakeholders are a critical element of any reporting network. As their needs and demands change, so must the reports produced by any such 'network' to remain relevant. Secondly, stakeholder-neutrality and relevance sit together uneasily. We would prefer an approach that is explicit and strong on reporting obligations and, in terms of PIE's, puts reporting in the public interest as the primary matter of concern.

6. Should materiality be dependent upon the objective of a report?

Yes, but it needs to be determined through direct reference to the interests of those to whom there is a public obligation to report. It should not be abstractly predetermined.

7. Is there a need for regulatory standards for non-financial reporting? What would be the scope of non-financial reporting in such standards?

What is needed is behavioural change on the part of companies and consumers. If IFRS standards, and the accounting model embedded in them, remain wedded to the IASB's definition of decision-usefulness and the aim of shareholder value maximisation, no set of International Sustainability Reporting Standards or other non-financial reporting standards is likely to achieve the behavioural change necessary to realise the UN Sustainable Development Goals by 2030 or years after.

Reducing environmental damage and creating a more equal and fair society demands a more responsible, sustainable and realistic form of capitalism – and this can be facilitated by a fundamental change in the way in which accounting and auditing standard setters and regulators frame their own public interest responsibilities and, in the process, shape and influence the reporting obligations and strategic considerations of PIEs. As such, consideration of the non-financial reporting requirements and related reporting standards has to be preceded by a deeper contemplation of the public interest reporting obligations of PIE's. It is such obligations that ultimately shape the scale and balance of financial and non-financial reporting.

8. Should companies provide information about how they view their obligations in respect of the public interest?

Companies in themselves cannot really have a view but, as our response has made very clear, we believe that those responsible for the operation of a PIE (i.e., its directors) have to delineate, respect and discharge the entity's responsibilities to serve the public interest. Such responsibilities derive from the entity's legal form, size, listing status, tradability of its securities and overall capacity to utilise societal resources and affect social wellbeing.

9. Do you agree with the introduction of a Public Interest Report as set out in Section 6 of the Discussion paper?

As far as we can see from the detail provided in the DP, the purpose and content of its suggested Public Interest Report largely duplicates what is already provided by the existing sustainability report. Progress towards international sustainability reporting standards is imminent, and like IFRS standards, such standards will be relevant for UK PIEs.

As we have made clear in answers to other questions, public interest reporting has, by definition, to be at the centre of any corporate reporting system for PIEs. We very much welcome the FRC DPs commitments in this regard but believe that its intentions can best be delivered by requiring PIEs to publish a combined Public Interest Statement and Business Report.

10. In what ways could technology support the reporting model and system level attributes outlined in the Discussion paper?

There is a multiplicity of potential options here, from the easing of access to information, the connectedness of reported information (and the ability to compare information across companies and databases) to the frequency of reporting and the capacity to interrogate further reported information.

However, these are implementation issues that are secondary to the determination, acceptance and stipulation by the FRC as to the essentiality of public interest reporting, the rights of stakeholders and the obligations of PIEs. In addition, these issues are best connected to the promotion of a spirit of innovation and opportunity in the practical domain of public interest reporting practice. Getting the principles of public interest reporting agreed first has to be the priority.

11. Would the proposed model achieve a proportionate reporting regime for companies of different sizes and complexity?

In principle, the model as amended by our suggestions can be applied to any reporting regime because the value created, and the externalities generated, by the business model would be at the core of the Public Interest Statement and Business Report.

12. In what other ways can corporate reporting be made fit for the future?

The core issue here is not the specification of 'other ways' but one of judging 'fitness for the future'. The ultimate test of fitness for corporate reporting is what it achieves. As a society, we will not know until today's future becomes tomorrow's present.

We close our submission by emphasising the importance of the opportunity provided by the DP to place public interest reporting centre stage in any contemplation of the future of corporate reporting. By being centre stage, PIE reporting will be able to impact on the nature of corporate behaviour and its social impact. We believe that the achievement of such positioning can be greatly assisted by explicitly integrating, as recommended above, a Public Interest Statement within the Business Report.

Future corporate reporting must play its part in ensuring that capital markets allocate capital to companies that use capital efficiently to produce goods and services that customers want, jobs that people need, and generate returns for shareholders and other investors whilst protecting the general public interest by being transparent about any third party effects that are generated in the process and committing to minimising and eradicating them.

Future corporate reporting must impact on corporate, individual and societal behaviour because business as usual is not going to generate the changes required to create prosperity for all in responsible and sustainable ways.

References

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