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## **ESRS: Governance architecture Issues Paper**

### **Objective**

- 1 The objective of this paper is to summarise the preliminary feedback received on the architecture of the governance requirements in the draft ESRS EDs and to discuss possible alternatives.

### **Background**

- 2 The requirements related to governance can be found in three places in the ESRS ED's:
  - (a) ESRS 2 *General, strategy, governance and materiality assessment*,
  - (b) The topical standards where relevant; and
  - (c) ESRS G1 *Governance, risk management and internal control*.
- 3 This reflects the pervasiveness and importance of governance as each of these deals with the topic at a different level:
  - (a) ESRS G1 have disclosure requirements about the overarching governance of the undertaking given its importance to the sustainability and longevity of the undertaking itself;
  - (b) ESRS 2 then prescribes the disclosure requirements around the governance of sustainability matters; and
  - (c) The specific governance aspects relating to the other topics are covered in the relevant standards.
  - (d) ESRS G2 deals with business conduct and is therefore dealing with different topics.

4 This can be graphically represented as follows:



### Changes to CSRD and consequences in terms of content of G1

5 The changes to CSRD clarified that:

- (a) the DRs relating to governance should cover the factors that are listed in international frameworks, such as:
  - (i) GRI<sup>1</sup>,
  - (ii) TCFD<sup>2</sup>,
  - (iii) Global Governance Principles of the International Corporate Governance Network<sup>3</sup>
  - (iv) G20 OECD principles of Corporate Governance<sup>4</sup>.

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<sup>1</sup> The following aspects are covered: Disclosure 2-9 Governance structure and composition, Disclosure 2-10 Nomination and selection of the highest governance body, Disclosure 2-11 Chair of the highest governance body, Disclosure 2-12 Role of the highest governance body in overseeing the management of impacts, Disclosure 2-13 Delegation of responsibility for managing impacts, Disclosure 2-14 Role of the highest governance body in sustainability reporting, Disclosure 2-15 Conflicts of interest, Disclosure 2-16 Communication of critical concerns, Disclosure 2-17 Collective knowledge of the highest governance body, Disclosure 2-18 Evaluation of the performance of the highest governance body, Disclosure 2-19 Remuneration policies, Disclosure 2-20 Process to determine remuneration, Disclosure 2-21 Annual total compensation ratio.

<sup>2</sup> The following aspects are covered: Describe the board's oversight of climate-related risks and Opportunities, and Describe management's role in assessing and managing climate-related risks and opportunities.

<sup>3</sup> The following aspects are covered with respect to the Board: responsibilities, leadership and independence, composition and appointment, corporate culture, risk oversight, remuneration, reporting and audit, general meetings, shareholder rights. The following aspects are covered with respect to the Institutional Investors: Responsibilities, leadership and independence, capacity, Conflict of interest, Remuneration, Monitoring, Engagement, Voting.

<sup>4</sup> The following aspects are covered: ensuring the basis for an effective corporate governance framework, the rights and equitable treatment of shareholders and key ownership functions, institutional investors, stock market and intermediaries, the role of stakeholders in corporate governance, disclosure and transparency, the responsibility of the Board,

- (b) the DRs in G1 relating to risk management and internal control should be relating to the sustainability reporting process rather than in general.

6 The text of recital 44 has been amended.

Old text	New text
<p><i>Users need information about governance factors, including information on the</i></p> <p><i>role of an undertaking's administrative, management and supervisory bodies, including with regard to sustainability matters, the composition of such bodies,</i></p> <p><i>and an undertaking's internal control and risk management systems, including in relation to the reporting process.</i></p> <p><i>Users also need information about undertakings' corporate culture and approach to business ethics,</i></p> <p><i>including anti-corruption and anti-bribery, and about their political engagements, including lobbying activities. Information about the management of the undertaking and the quality of relationships with business partners,</i></p> <p><i>including payment practices relating to the date or period for payment, the rate of interest for late payment or the compensation for recovery costs referred to in Directive 2011/7/EU of the</i></p>	<p><i>Users need information about governance factors. Governance factors that are most relevant to users are listed by authoritative reporting frameworks such as the Global Reporting Initiative and the Task Force on Climate-related Financial Disclosures, as well as by authoritative global frameworks such as the Global Governance Principles of the International Corporate Governance Network and the G20 OECD principles of Corporate Governance. Sustainability reporting standards should specify the information that undertakings should disclose on governance factors.</i></p> <p><i>Such information should cover the role of an undertaking's administrative, management and supervisory bodies with regard to sustainability matters, expertise and skills to fulfil this role or access to such expertise and skills, whether the company has a policy in terms of incentives offered to members of these bodies which are linked to sustainability matters, and information on an undertaking's internal control and risk management systems in relation to the sustainability reporting process.</i></p> <p><i>Users also need information about undertakings' corporate culture and approach to business ethics, <b>which are recognised elements of authoritative frameworks on corporate governance such as the Global Governance Principles of the International Corporate Governance Network, including information about anti-corruption and anti-bribery, and about the undertaking's political engagements, including lobbying activities. Information about the management of the undertaking and the quality of relationships with customers, suppliers and communities affected by the activities of the undertaking, helps users to understand an undertaking's risks as well as its impacts on sustainability matters. Information about relationships with suppliers, includes</b> payment practices relating to the date or period for payment, the rate of interest for late payment or the compensation for recovery costs referred to in Directive 2011/7/EU of the European</i></p>

<p><i>European Parliament and of the Council<sup>62</sup> on late payment in commercial transactions, helps users to understand an undertaking's risks as well as its impacts on sustainability matters.</i></p> <p><i>Every year, thousands of businesses, especially SMEs, suffer administrative and financial burdens because they are paid late, or not at all. Ultimately, late payments lead to insolvency and bankruptcy, with destructive effects on entire value chains. Increasing information about payment practices should empower other undertakings to identify prompt and reliable payers, detect unfair payment practices, access information about the businesses they trade with, and negotiate fairer payment terms.</i></p>	<p><i>Parliament and of the Council<sup>34</sup> on late payment in commercial transactions.</i></p> <p><i>Every year, thousands of businesses, especially SMEs, suffer administrative and financial burdens because they are paid late, or not at all. Ultimately, late payments lead to insolvency and bankruptcy, with destructive effects on entire value chains. Increasing information about payment practices should empower other undertakings to identify prompt and reliable payers, detect unfair payment practices, access information about the businesses they trade with, and negotiate fairer payment terms.</i></p>
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- 7 The updated CSRD also emphasises diversity matters as an important factor for sustainability and continues to require disclosures about the composition of the administrative, supervisory and management bodies.
- 8 The revised text may be interpreted as requiring a narrower scope of matters that refer to the general Governance, in particular it is now questionable whether the following DRs should still be inside the scope of what is requested by the CSRD:

<b>DR G1-2</b> – Corporate governance code or policy
<b>DR G1-3</b> – Nomination process
<b>DR G1-5</b> – Evaluation process
<b>DR G1-6</b> – Remuneration policy
<b>DR G1-10</b> – Meetings and attendance rate

- 9 In addition, DR G1-7 Risk management process and DR G1-8 Internal control processes after the changes to the CSRD have to deal only with sustainability reporting, while currently they have a broader scope.
- 10 Once modified, DR G1-7 and G1-8 would probably fit better in ESRS 2 rather than included in ESRS G1, as they cover cross-cutting aspects of sustainability governance.

### Early feedback and GRI comments

- 11 Based on the feedback received during the outreach events, questions to the Secretariat and the EFRAG Use Test Focus Group, some find the current architecture of the requirements around governance confusing. We also received feedback that DRs overlap between ESRS 2 and ESRS G1 due to the same issue being covered from two perspectives: the governance of the undertaking as a whole and/or the governance relating to sustainability matters.

- 12 There were also comments that the requirements of ESRS G1 should be included in ESRS 2 to reduce the complexity and to ensure that the DRs in G1 would not be subject to the rebuttable presumption.
- 13 GRI provided the following comments with respect to the architecture of the governance standards:
- “GRI strongly recommends that the disclosure requirements in ESRS G1 be moved into the cross-cutting standard ESRS 2. The information required by these disclosures is essential in order to understand an undertaking’s governance and cannot be subjected to an undertaking’s materiality assessment. ... GRI also recommends including GRI 2-15 on conflicts of interest in ESRS 2 alongside the other governance disclosures from ESRS G1.”
- “GRI strongly recommends that disclosures on general policies and processes (e.g., whistleblowing) for responsible business conduct be moved into the cross-cutting standard ESRS 2, in line with GR’s approach, as materiality judgements should not apply to these disclosures. GRI further recommends that these disclosures be further aligned with the disclosures in the GRI Standards, which have been recently revised to be consistent with expectations in authoritative intergovernmental instruments. GRI proposes this ESRS be then limited to anti-corruption and anti-bribery and other practices and be renamed accordingly.”
- 14 In the context of the changes to the CSRD, there could be an opportunity to review the location of the requirements in ESRS G1 and G2.
- 15 Another factor, which may be relevant is that some call for DR ESRS 2-GOV2 and GOV3 in ESRS 2 to be merged into one DR, resulting in four governance DRs in the standard.

#### **Available alternatives**

- 16 The EFRAG Secretariat considers the following possible alternatives in the remainder of this paper:
- (a) No change with better signposting and explanations;
  - (b) All governance aspects to be included in ESRS 2; or
  - (c) All governance aspects to be included in ESRS G1.
- In b) and c) the proposal is that business conduct aspects remain in ESRS G2.
- 17 The EFRAG Secretariat notes that application of the rebuttable presumption can be settled separately from any decision about the architecture, either by amending ESRS 1 paragraph 61 or with specific guidance that the governance topics are always material. However, the EFRAG Secretariat does not consider that the ESRS G2 policies and processes are always material as this would depend on the impact assessment under the ESRS framework. Furthermore, including these policies in ESRS 2 may raise the possibility that all policies under the topical standards should be in ESRS 2 increasing complexity.

#### *No change*

- 18 In the context that the overall structure of ESRS had been developed over time intending to provide equal prominence to the three topics while also dealing with the cross-cutting aspects of the framework, a change at this late stage does not seem appropriate.
- 19 While the simpler structure of ESRS G1 given the CSRD changes would reduce confusion, the architecture and the related rationale would have to be carefully explained in a cover note and/or the basis for conclusions. Depending on the decision of which DRs in ESRS G1 would remain in G1, this standard could include very few DRs and this would be unique in the ESRS framework.

All requirements in either ESRS 2 or ESRS G1

- 20 This would be considered a simplification by many who do not understand the rationale for the current architecture. However, it would mean that either a topical or cross-cutting perspective would be omitted from the ESRS structure. It would be counterintuitive to have no standard referencing governance in its title in the governance pillar.
- 21 Another concern is whether there would be unintended consequences to these kind of structural changes this late in the drafting process. Based on these reasons the EFRAG Secretariat favours either no changes to the architecture or having all requirements in ESRS G1 (and G2 for the Business conduct aspects).
- 22 A visual representation of the standards under the three options<sup>5</sup>:

No change	All GOV DRs in ESRS 2 or in ESRS G1
<ul style="list-style-type: none"> <li>• <b>ESRS 2 with 5<sup>6</sup> (or 6) DRs</b></li> <li>1. Roles and responsibilities of governance bodies (wrt sustainability matters)</li> <li>2. Information of AMSB about sustainability matters</li> <li>3. Sustainability matters addressed by the undertaking's AMSB.</li> <li>4. Integration of sustainability strategies and performance in incentive schemes</li> <li>5. Risk management and internal control over sustainability reporting process</li> <li>6. Statement on due diligence</li> <li>• <b>ESRS G1 with 3<sup>7</sup> DRs</b></li> <li>1. Governance structure.</li> <li>2. Diversity policy</li> <li>3. Composition of the administrative, management and supervisory bodies</li> </ul>	<ul style="list-style-type: none"> <li>1. Governance structure.</li> <li>2. Diversity policy</li> <li>3. Roles and responsibilities of governance bodies (wrt sustainability matters)</li> <li>4. Information of AMSB about sustainability matters</li> <li>5. Sustainability matters addressed by the undertaking's AMSB.</li> <li>6. Integration of sustainability strategies and performance in incentive schemes</li> <li>7. Risk management and internal control over sustainability reporting process</li> <li>8. Composition of the administrative, management and supervisory bodies</li> <li>9. Statement on due diligence</li> </ul>

**Questions for EFRAG SR TEG**

- 23 Do EFRAG SR TEG members consider that in the light of the revised CSRD there is a need to reduce the DRs in G1? If yes, which DRs in G1 should be eliminated?
- 24 Do EFRAG SR TEG agree to narrow down the content of DR G1-7 and G1-8 and refer it only to sustainability matters? Do EFRAG SR TEG agree to move them into ESRS 2?
- 25 Do EFRAG SR TEG agrees with the GRI recommendation that the DRs in ESRS G1 and the general policies and processes (e.g., whistleblowing) for business conduct (i.e. ESRS G2) should be mandatory in all cases? If not, which DRs in

<sup>5</sup> As discussed previously, DR G1-2, G1-3, G1-5, G1-6 and G1-10 are proposed to be deleted due to the changes to CSRD.

<sup>6</sup> This would reflect the combining of GOV2 and GOV3, plus the additions of G1-7 and G1-8 in one DR to ESRS 2.

<sup>7</sup> This is on the assumption that the DR on diversity policy (G1-4) remains in ESRS G1.

- G1 and/or G2 should be mandatory in all cases (outside the scope of the rebuttable presumption/materiality assessment)?
- 26 Do EFRAG SR TEG considers that the remaining DRs in G1 should be moved into ESRS 2 or should remain in ESRS G1?
- 27 Do EFRAG SR TEG agrees that GRI 2-15 on conflicts of interest should be added to the DRs and presented alongside the other governance disclosures now in ESRS G1?
- 28 Which of the three options discussed in paragraph 16 does EFRAG SR TEG recommend to the EFRAG SRB?

**Appendix 1: List of DRs in [ESRS G1](#)**

*General, strategy, governance and materiality assessment*

DR G1-1 – Governance structure and composition

*Policies, targets, action plans and resources*

DR G1-2 – Corporate governance code or policy

DR G1-3 – Nomination process

DR G1-4 – Diversity policy

DR G1-5 – Evaluation process

DR G1-6 – Remuneration policy

DR G1-7 – Risk management processes

DR G1-8 – Internal control processes

*Performance measurement*

DR G1- 9 – Composition of the administrative, management and supervisory bodies

DR G1-10 – Meetings and attendance rate

**Appendix 2: List of DRs in [ESRS G2](#)**

*General, strategy, governance and materiality assessment*

DR G2-1 – Business conduct culture

*Policies, targets, action plans and resources*

DR G2-2 – Policies and targets on business conduct

DR G2-3 – Prevention and detection of corruption and bribery

DR G2-4 – Anti-competitive behaviour prevention and detection

DR G2-5 – Anti-corruption and anti-bribery training

DR G2-6 – Corruption or bribery events

DR G2-7 – Anti-competitive behaviour events

DR G2-8 – Internal Beneficial ownership

*Performance measurement*

DR G2-9 – Political engagement and lobbying activities

DR G2-10 – Payment practices