Reform of the EU Non-Financial Reporting Directive

Joint position

Alliance for Corporate Transparency

The EU Non-Financial Reporting (NFR) Directive mandates large listed EU companies and financial corporations to disclose information on environmental, social, human rights and anti-corruption matters, necessary to understand a company's position, performance, development and impacts. More specifically, companies falling under the scope of the NFR Directive are requested to disclose information on their business model, policies and due diligence and the outcomes of these policies, principal risks, and key performance indicators (KPIs) with respect to environmental and social issues relevant to their business.

However, the NFR Directive fails to define which specific information and KPIs companies must disclose, nor the specific matters they should address. Furthermore, the general reporting requirements listed in the Directive allow contradicting interpretations, all of which undermines the objective of the law to increase the consistency and comparability of sustainability information.

As shown by the research of the Alliance for Corporate Transparency, the quality of corporate reporting practices varies among EU companies and across Member States. Notably, most undertakings in all Member States fail to disclose relevant, material, meaningful and comparable sustainability information, calling for the need to clarify and further specify reporting requirements for companies in Europe. For example, while most companies report general policy commitments to climate change and human rights (88% and 82% respectively), a much smaller fraction report relevant and meaningful information; only 36.2% of companies report on their climate targets, and an even lower percentage report on the alignment of such target with the Paris Agreement/Science Based Target (13.9%). Similarly, only 23% of companies report on the determination of salient human rights issues, and less than 4% report examples illustrating effective management of salient issues (3.6%) .

Improving the quality of corporate reporting is critical on numerous fronts. It is central to the achievement of EU goals as set out in the EU Green Deal and Sustainable Finance Action Plan; corporate transparency on sustainability issues is essential to allow financial actors to redirect capital flows towards sustainable investments, and ensure better management of risks stemming from climate change, environmental degradation and social issues. The focus on the right data is critical for companies' ability to make informed decisions and successfully adapt to the fast-changing world. Moreover, it can positively contribute to increased corporate accountability for serious adverse impacts on the environment and society.

In this context, the Alliance for Corporate Transparency strongly welcomes the European Commission's commitment to reform the EU Non-Financial Reporting Directive and explore the development of future mandatory EU non-financial reporting standards. These processes offer a unique opportunity to address the gaps and shortcomings of corporate sustainability reporting, which in turn will support smoother achievement of EU goals.

However, the complexity of the issue and multiple and varied interests in these developments could severely undermine the successful outcome of the reform and lead to the focus on information that does not provide useful insights to companies, investors and other stakeholders. To address these obstacles and contribute to a meaningful EU process for the standardisation of reporting requirements in favour of comparable, concise and relevant disclosure, the members of the Alliance for Corporate Transparency have combined their expertise and aligned on key priorities for reform of the EU NFR Directive and development of possible future standards.

Outline of recommendations developed in the joint position:

1. Expansion of the scope of the EU Non-Financial Reporting Directive
2. Alignment with the annual report
3. Clarification of the double-materiality definition and principles
4. Reporting requirements on governance and sustainability integration
5. Better definition and connectivity of general reporting requirements in the Directive
6. Specification of thematic and sector-specific reporting requirements for climate, natural resources and biodiversity, workforce information, human rights and environmental due diligence, and anti-corruption
7. Requirement for mandatory assurance

1. SCOPE. Expand the scope of the EU Non-Financial Reporting Directive so as to cover:

- **All public interest companies, irrespective of their size, including non EU companies which securities are admitted to trading in the EU**

Rationale: In order to meet their own disclosure obligations (as per the Disclosure and Taxonomy Regulations), investors need high-quality information concerning all securities they are investing in, irrespective of the size of the issuer. Furthermore, smaller public interest entities would be disadvantaged if left out of the scope of the legislation, as they would become less visible to investors and would not be guided to collect critical data for their own decision making. Non EU companies trading securities in the EU should be included to ensure a level-playing field.[1] Similarly, all credit and insurance undertaking play an important role in the finance system and should be included as well.

- **All large companies as defined in the Accounting Directive, that is fulfilling 2 out of the following 3 criteria:**

  - Balance sheet total of at least EUR 20 million
  - Net turnover of EUR 40 million
  - Minimum 250 employees

Rationale: Large private companies are linked to the same risks and impacts as public interest companies, and additionally rely on bank loans for capital; thus the same transparency requirements should apply as in the case of publicly traded undertakings.[2] The definition of 'large undertakings' under the Accounting Directive uses an average threshold of 250 employees, while the NFRD definition uses a twice higher threshold: this is inconsistent and there is no meaningful justification about this difference. The threshold of 250 employees should be chosen for the NFRD to ensure consistency.

- **All small and medium-sized companies whose business activities are linked to significant impacts** (the conditions for determination of significant impacts, that could potentially build on a list of high-impact activities should be specified in Level 2 legislation or in other legislative acts):

  - Medium sized companies are defined as such when fulfilling 2 out of the following 3 criteria:
    - Balance sheet total of at least EUR 4 million
    - Net turnover of EUR 8 million
    - Minimum 50 employees

  - Small companies are defined as those fulfilling at a minimum 2 out of the following 3 criteria:
    - Balance sheet total of at least EUR 350 thousand
    - Net turnover of EUR 750 thousand
    - Minimum 10 employees

Rationale: SMEs whose business activities are linked to significant risks will benefit from a clarification of which information is critical for their businesses. The NFR standards can play a useful role in this regard by simplifying and standardising reporting requirements, thus lowering costs for SMEs and helping them to focus on data and indicators important for their development and success and access to capital. Furthermore, including SMEs that have major human rights and environmental impacts is necessary to ensure policy coherence with the upcoming environmental and human rights due diligence legislation.

- **Financial market participants** based on a specific threshold to be defined that reflects assets owned, managed or controlled

Rationale: Including financial market participants irrespective of size, but reflecting turnover and assets owned, managed or controlled is critical since there are financial actors with very few employees managing large assets for their clients (easily meeting the turnover criteria for large undertakings, facing environmental and social impacts and risks), yet this is not shown in their balance sheet.

2. ALIGNMENT WITH THE ANNUAL REPORT

- Ensure that the **non-financial statement is made available together with the annual report** and that financially material information is disclosed and treated as any other material financial information provided by regulated issuers.

Rationale: The exclusion from the annual report of material sustainability information has two significant negative effects: (i) complicates the integration of this relevant information in a company's strategy and governance, and (ii) limits the accessibility, reliability and decision-usefulness of information by users.

3. DOUBLE-MATERIALITY: Clarify the double-materiality definition and principles based on the following:

- In order to define the focus of corporate disclosure (that is, material issues), **undertakings should consider which information is relevant from the perspective of their economic, social and environmental dependencies** (information necessary for an understanding of the company's development, performance and position and/ or resilience from a financial perspective) **and from the perspective of understanding their impact on people and the environment**
- Materiality from the '**impact' perspective means information about severe actual negative impacts and potential negative impacts on people and/or the environment** that are caused, contributed to or directly linked to the company's operations, products or services by its business relationships. Severity is judged according to the scope, scale or irremediability of the potential or actual impact on the environment and/or on people.[3]
- Information concerning severe impacts is material irrespective of the assessment of whether it is considered material or likely material from the perspective of the undertaking's economic development, performance and position.
- Materiality from the 'financial' perspective, as per Art 2(16) of the Accounting Directive: *"material means the status of information where its omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking*", extended to the management report as a whole.

Rationale: It is important that companies reflect both dimensions of materiality. In practice, however, it is not clear why specific reported issues are considered material - whether due to financial risks faced by the company, or due to impacts they are causing/contributing to people and the environment - and thus how significant such risks and impacts are. Such a lack of clarity on materiality undermines the relevance of any information disclosed on an issue, as it leads to unfocused and immaterial disclosures with little value for the company's management and its stakeholders.

The financial materiality is already defined in the accounting law, it is just not followed in practice for sustainability matters.

As regards the impacts perspective, the focus should be placed on the positive and negative effects of the company's actions on social and environmental issues directly linked to the company's business model, rather than any socially responsible activities, and specifically on severe impacts, taking into account global and local sustainability context including planetary boundaries, the governance, rule of law and human rights context and the level of stress of local environmental and social conditions.

4. GOVERNANCE AND ACCOUNTABILITY: Integrate reporting requirements covering the issues of governance and accountability for sustainability matters:

- The same conditions should apply as in the case of financial statements and the management report
- Introduce a **requirement mandating undertakings to describe the board's oversight of and management's role in assessing and managing of non-financial risks and opportunities**; and
- Ensure transparency on integration into overall corporate strategy:

  - Introduce a **requirement mandating undertakings to report on the integration of the non-financial risks, impacts, opportunities, policies and targets** in the overall business strategy;
  - Provide a **mandate to the EU standard setter to develop an appropriate standard for reporting on integration of thematic information** in a corporate strategy as whole

Rationale: The common problem in practice is that sustainability matters are considered as CSR activities that are not relevant to core business strategy-planning. A standardized disclosure concerning the level of integration of company sustainability strategies and KPIs into the company's overall corporate strategy and into the Board's mandate would contribute significantly to the materiality of disclosures and will help companies to consider which sustainability information has strategic relevance. For investors it would make it easy to distinguish companies which take sustainability matters into account at strategic level.[4]

5. GENERAL REPORTING REQUIREMENTS. For each issue reported on, based on the application of the double materiality principle and the thematic requirements and corresponding EU reporting standards (see Section 6), disclosures should include a description of:

- Segments of the **company business model**, including assets (inputs into, and outputs out of the business model), business activities (incl. relationships) and outcomes of the business model (internal and external, both positive and negative) related to the issue
- **Material risks and opportunities** facing the company arising from each issue and **how these are included into the company's risk management process**
- The **most significant actual impacts and risks of such impacts on people and the environment**, alongside an **indication of where in the value chain** these impacts and risks are concentrated (the scope of the analysis should include the entire value chain)
- The **strategy put in place** by the company to address the identified impacts, risks and opportunities, **including actions taken** and any changes to the business model
- **Targets or objectives and timelines for achieving them** concerning the identified impacts, risks and opportunities expressed, where possible, in quantitative terms; **and performance against those targets, including KPIs** used to monitor them
- **Information required by the EU taxonomy** (including provision to include any further updates that may be made to include further issues)
- Information outlined in **specific reporting requirements and corresponding EU reporting standards** (see pt 7) related to the reporting issue

Rationale: The list provides a specification how the key requirements that are already included in the NFRD should be implemented by companies in a connected way. The proposed specification aims to address the problem that companies' disclosure of policies and related targets and outcomes is often disconnected from assessment of impacts and risks. This further contributes to immaterial disclosures, as well as omissions of key information and data.[5]

Furthermore, companies often don't describe their policies from a forward-looking perspective - it is not clear what policies are meant to achieve and when. Finally, for the double materiality approach to be well understood, the legislation must clarify the difference between the two perspectives and confirm that both impacts on people and the environment and economic risks and opportunities (such as those connected to decarbonisation of the economy) for the company need to be considered.

Currently, reporting on both dimensions of materiality is merged in the NFRD in a single requirement, complicating the understanding among practitioners.

6. THEMATIC REPORTING REQUIREMENTS: In addition to the information requirements in Section 5 above, undertakings should report the thematic information specified below.

- The European Commission should adopt mandatory reporting standards for these issues, outlining sector specifications for the most impactful and high-risk sectors, as well as clarifying business activities and thresholds for and above which such issues should be deemed as material by the company. Requirements marked with (*) should be universally applicable to all companies irrespective of their sector. As such, the following specific requirements should be included in Level 1 legislation and specified by bespoke sector-sensitive reporting standards at Level 2:

- **Climate** (mitigation and adaptation)

  - The resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 1.5°C scenario (as recommended by the TCFD) (*)

Rationale: Companies play a critical role in ensuring the achievement of international goals such as those set out in the Paris Agreement and European Green Deal. To ensure investors can redirect capital flows towards sustainable investments, fulfil their own reporting obligations[6] and to ensure alignment with other pieces of legislation,[7] companies will need to disclose specific climate-related indicators,

- Climate change mitigation target and the extent to which it aligns the company's business model with the Paris Agreement's goal of limiting global warming to 1.5°C, or the latest evolving goals based on climate science recommended by the IPCC, the timeline, the climate scenario chosen;
- GHG emissions scope 1,2,3
- Sector-specific metrics from the Taxonomy

in line with those suggested here. Most companies fail to provide forward-looking information, and while certain forms of disclosure are streamlined (e.g. reporting on emissions and emission intensity), methodologies are highly divergent in particularly as concerns Scope 3 emissions that should cover the impacts generated in the value chain, which prevents reported data from being reliable, comparable and as a consequence decision-useful.

› **Natural resources, biodiversity and ecosystems,** structured consistently with the EU taxonomy' environmental objectives:

- Targets and timelines (or planned target, by when) to mitigate the undertaking's adverse impacts concerning water and marine resources; circularity and waste; pollutants; biodiversity and ecosystems (including deforestation), and whether such targets are science-based
- Water use in water-stressed areas (*)
- Direct use of land
- Direct biodiversity impacts (*)
- Use of risk commodities and share that is sustainably produced
- Air and water pollution
- Waste

Rationale: Reporting on the environmental issues listed above is less common, despite them being material for many companies. Moreover, it is typically limited to reporting on policies, whereas reporting on risks is often missing, as shown by the research of the Alliance for Corporate Transparency:
- The only KPI which is commonly used is use of water (59.5%); however, very rarely do companies contextualise such KPI with a view to water-stress (10.6%);
- Reporting on biodiversity is particularly difficult. There doesn't seem to be a common understanding of what the key issues are, nor how to report on them, suggesting gaps in existing voluntary standards. EU standards must provide methodologies, specify thresholds and clarify the level of application of indicators as regards the impacts in the supply chains for the above mentioned issues to ensure that reporting enables proper understanding of a company's position, performance, development, and impact.

› **Workforce and human rights matters**

- Information regarding (employees and other workers under company's control)
    - Workforce composition and stability (*)
    - Gender pay gap(*)
    - Living wage (*)
    - Collective bargaining coverage (*)
    - Worker participation in OHS system design and implementation

Rationale: The information currently reported by companies is not clear enough for interested stakeholders to understand how undertakings manage impacts on employees; the above reporting requirements address such a shortcoming. The details regarding workforce composition should be determined in standards, but should include at minimum diversity; share of full time and part time employees, and data on precarious and outsourced labour.

- Information aligned with the requirements of the United Nations Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises: description of human rights policy commitment, human rights due diligence processes, including the most severe human rights risks and impacts identified, the actions to prevent and mitigate those impacts, including the targets and outcomes, and the processes to enable remediation of human rights impacts, including effective grievance mechanisms (*)

Rationale: The implementation of due diligence is part of an obligation for companies to respect human rights as set out in the United Nations Guiding Principles on Business and Human Rights; reporting on due diligence is a step of such process (reporting on due diligence, however, should not be confused with conducting proper due diligence, which involves further obligations other than disclosure).

- Specific human rights policies and their outcomes (if material) concerning:
    - Protection of human rights defenders (*);
    - Free, prior and informed consent of indigenous people (*);
    - Land rights and access to water by people (*),

- Additional information regarding supply chain management:
    - Disclosure of suppliers in high-risk supply chains
    - Purchasing practices

Rationale: The information currently reported by companies is not clear enough for interested stakeholders to understand how undertakings manage impacts on people. Most severe impacts occur in the supply chain - transparency is therefore critical to ensure companies provide information on their human rights policies and the identification/management of risks and impacts. In this regard, the current array of indicators provided in reporting standards do not facilitate disclosure of reliable and useful data that would provide comparable insights. Instead, the focus in the EU reporting standards should be placed on determining a limited set of meaningful cross-cutting indicators with a supportive function, corresponding to the indicators applied to own employees (including workforce

- Workforce statistics (aligned with the disclosure requirements concerning own employees)
- % of products manufactured under living wage and collective bargaining conditions
- KPIs regarding sourcing of conflict minerals

composition, gender pay gap, living wage, collective bargaining, the data for which can be obtained for Tier 1). These indicators should be applied by companies whose business model relies on sourcing from high-risk supply chains. The relevant conditions and thresholds for applicability needs to be specified in the EU standards. Transparency must also entail the publishing of suppliers that are the source of the high risk to enable external verification of the implementation of due diligence policies, in particular by affected people and civil society. In some industries, such as garment and footwear, a full disclosure of Tier 1 suppliers and manufacturing sites is appropriate and an increasingly common practice, whereas for disclosure of suppliers at lower Tiers detailed specific rules and thresholds need to be clarified.

› **Anti-corruption**

- Results of risk assessment (*)
- Anticorruption programmes (*)
- Whistleblowing systems and results (*)
- Information on beneficial ownership and organisational structure (fully consolidated subsidiaries, affiliates, joint ventures and non-fully consolidated holdings, as well as % owned in each of these entities) (*)
- Information on corporate political engagement (lobbying activities and costs; political donations and sponsorships; gifts and hospitality; policies on revolving doors and conflicts of interest)

Rationale: The research of the Alliance for Corporate Transparency shows that, as is the case when reporting on environmental matters and human rights, companies report on general A-C policies (91.8%) and commitments (72.7%), yet only few disclose details of their risk assessment (10%) or specific risks (9.1%). Another problem is the lack of details on the scope of companies' anti-corruption programmes (35.5%). Standardised reporting criteria can help to better understand the company's resilience to corruption risks.

7. ASSURANCE

› **Non-financial information should be subject to mandatory assurance**

Rationale: Third party assurance on non-financial information can assess and as a consequence strengthen the reliability of information disclosed by companies. Meaningful and cost-efficient assurance is however underpinned by clear standards that specify what concrete information needs to be disclosed by companies and what are the materiality thresholds for the disclosure of such information. In the absence of such standards, mandatory assurance may have a range of undesired effects, further contributing to confusion as to how decision-useful disclosures should look like and being excessively costly.

These proposals have been discussed and developed as part of the Alliance for Corporate Transparency, including the input and support from the following organisations:

Management and content partners

Frank Bold
Business & Human Rights Resource Centre
Future-Fit Foundation
WWF
Transparency International EU
sustentia innovación social

Advisory group

CDP Disclosure Insight Action
Themis Research
Germanwatch
SOMO
CORE
Oxfam
ShareAction
CDSB Climate Disclosure Standards Board
Publish What You Pay
ECCJ European Coalition for Corporate Justice
global witness

Footnotes

[1] The European Banking Federation calls for the inclusion of all listed companies, all large companies and those with high transition risk (see here)

[2] The European Central Bank identifies the expansion of the NFRD scope as crucial to ensure a level playing field (see here)

[3] This definition is aligned with the United Nations Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises

[4] The recent study on directors' duties prepared by EY for DG Justice provides clear conclusions to the EU Commission about the effects of excessive short-term pressures from capital markets in corporate governance and the lack of proper ESG integration in corporate strategies. From the Alliance research on 1000 EU companies disclosures, 54% did not indicate how sustainability is integrated in the Board's and senior management operations and mandate.

[5] The Alliance for Corporate Transparency research shows that while most companies identify issues such as climate change or human rights material, fewer companies report on policies, and of those that do, only a small minority reports on specific issues and objectives (in the case of climate change, 90.9%, 82.2% and 34.5% respectively).

[6] As of March 2020, investors will have to report pursuant to the Investors Disclosure Regulation; institutional investors will be requested to provide information on the adverse impacts of investment decisions and financial advice to enable end-investors to make informed investment decisions, which inevitably will have an impact on the investor requests for information from companies.

[7] Under the EU Taxonomy Regulation, companies falling under the scope of the EU Non-Financial Reporting Directive, will have to report on their proportion of the turnover, capital expenditure (CapEx) or Operating expenditure (OpEx) associated with environmentally sustainable economic activities

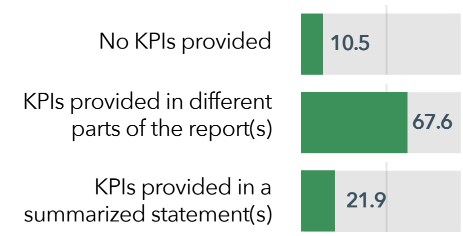
See Annex for an overview of key findings emerging from the research conducted by the Alliance for Corporate Transparency on the sustainability disclosures of 1000 EU companies

Annex: Overview of key findings emerging from the research conducted by the Alliance for Corporate Transparency on the sustainability disclosures of 1000 EU companies

Below, please find an overview of key findings emerging from the research conducted by the Alliance for Corporate Transparency on the sustainability disclosures of 1000 EU companies. These figures highlight widespread shortcomings in the corporate reporting practices of companies across Europe, as they fail to provide relevant and comparable information on sustainability risks and impacts. This underscores the need to strengthen corporate sustainability requirements to ensure meaningful corporate transparency on such issues.

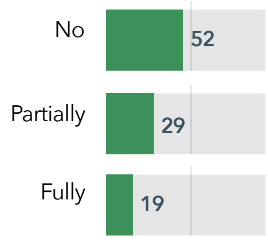
Presentation of information

KPIs presentation



Strategic perspective

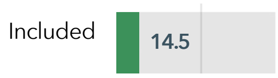
Key issues in the description of policies and risks in the main non-financial statement correspond with the overview of sustainability issues in the business model description



Governance

Integration of sustainability in the mandate of the Board and senior management

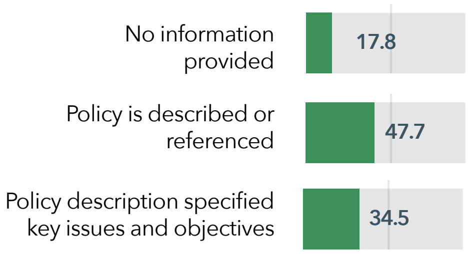
Information on how performance against ESG criteria affects executive compensation



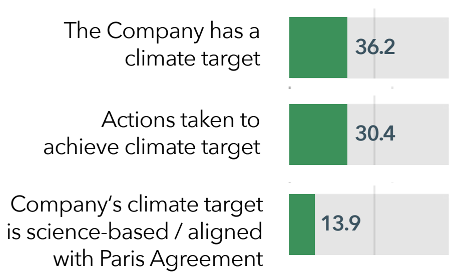
Sustainability matters addressed by the Board and decisions

Climate change

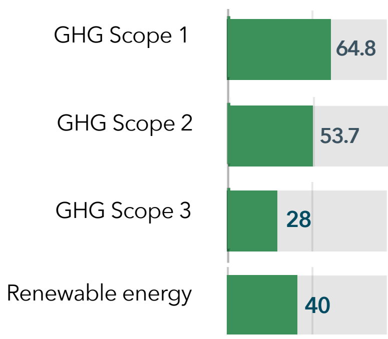
Policy description



Quality of policy disclosure



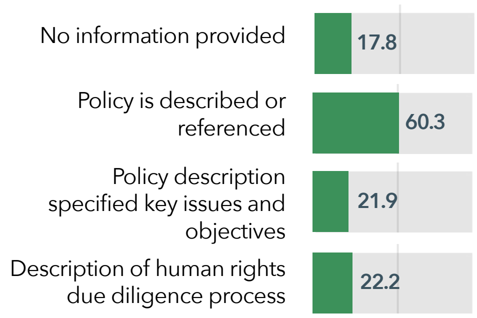
KPIs



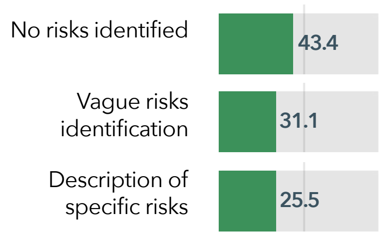
Outcomes

Human Rights Matters

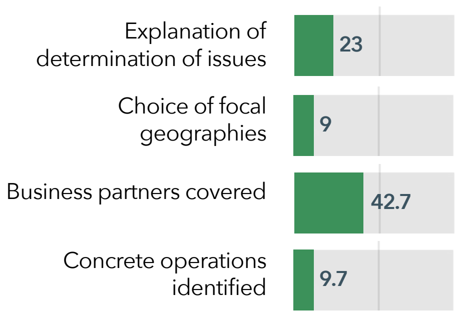
Policy description



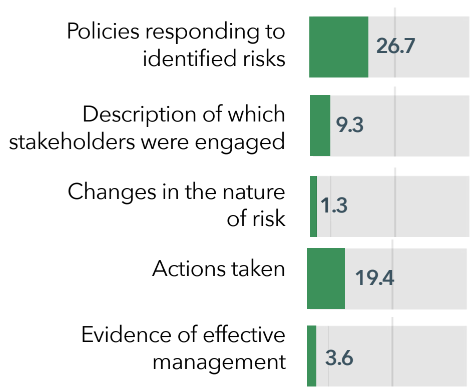
Statement of risks that could have a material financial impact on the organization



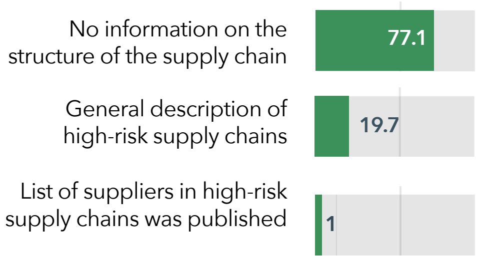
Determination and description of salient issues



Management of salient issues



Supply chain transparency



Employee Matters

Workforce statistics