Building a common EU framework for corporate non-financial reporting disclosures

SUSTAINABLE FINANCE

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Evolving to meet the needs of investors and requirements under the EU's sustainable finance regulatory regime

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Overview

Focus on the area of sustainable finance and related disclosures is ever-increasing. Sustainable finance in an EU context generally refers to the process of taking due account of environmental, social and governance (ESG) considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities. This focus on ESG arises not only from the emerging EU sustainable finance framework but also from investors, regulators and central banks worldwide.

In addition to the Sustainable Finance Disclosure Regulation (SFDR), the EU has pioneered, through the Taxonomy Regulation, the categorisation of sustainable activities. While the Taxonomy is still at a developmental stage, much of the detailed work has been undertaken by the Technical Expert Group (TEG) appointed to advise the Commission. It will become the new reference framework against which compliance regarding sustainability must be determined and disclosed.

Improving disclosures of "non-financial information"

Fundamental to compliance with the newly emerging EU sustainable finance framework is the need to improve disclosures relating to ESG, also referred to as "non-financial information". It is also widely recognised that users of this non-financial information are looking for greater transparency and consistency in what is being disclosed.

The European Commission has committed to reviewing the Non-Financial Reporting Directive (NFRD) during 2020. As part of this review, the European Commission launched an initial fact-finding consultation which ran until 11 June 2020.

We agree that the NFRD needs to be updated in view of the rapidly evolving area of sustainable finance and in particular to align the reporting obligations of investees/investors under the Taxonomy Regulation and the SFDR.

Our key comments on the NFRD review

- No single standard or reporting framework can currently satisfy all of the possible ESG-related preferences and requirements in this area. A targeted approach is needed, focussing on core data and qualitative information needed to comply with the new EU sustainable finance regime.
- The NFRD review also presents an opportunity for rationalisation of reporting in this space, building on the best elements of existing frameworks and standards.
- In order to address issues of fragmentation, costs and in the interests of transparency towards all stakeholders, we recommend that the underlying data be publicly available and reported via a common utility.
- It will be important to strike the right balance between the level of prescriptiveness and flexibility of the disclosures in order to provide a full understanding of a company's ESG profile achieve the intended outcome.
- A common reporting standard needs to allow for industry sector specific elements.
- The NFRD regime should not operate in isolation of other global sustainability disclosure frameworks that are already in place and convergence and rationalisation should be strived for in consultation with all key stakeholders.
- A well-defined materiality framework on an industry sector specific basis relating to non-financial information would aid in bringing clarity and consistency. This would also make the information and disclosures more relevant to the user, as they would be disclosed in line with industry sector guidelines.
- Independent third-party assurance over the non-financial disclosures will enhance the integrity and credibility of the information which is disclosed. A specific assurance standard will need to be developed and should be on an international and sector-specific basis. Transition in the level of assurance being provided (from limited to reasonable assurance) may be on a progressive basis given the evolving nature of this area.
- Not all information which is included within the annual report and financial statements (potentially including the disclosure of ESG risks which have been deemed to be financially material) is covered by the statutory audit opinion. Therefore, the potential for the non-financial information to be included in a separate report could be considered. While there are pros and cons to such an approach, having two separate reports would clarify to the reader the information which is covered by each opinion. This would also reflect the increasing importance of these non-financial disclosures.

The current NFRD (which was in itself an amendment to the Accounting Directive) is applicable to large public-interest companies with more than 500 employees.

In practice it has been applied to large listed companies and asset managers, banks and insurance companies (whether listed or not) with more than 500 employees. The NFRD requires disclosure of information from large companies' policies relating to environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery and diversity on company boards (not only relating to gender, but also age, educational and professional backgrounds).

The NFRD aims to strike a balance in prescribing certain information to be disclosed but allowing some flexibility such that the disclosure of relevant information is done in the way which is considered to be most useful to a reader of the annual report.

For example, companies can currently use international, European or national guidelines such as the United Nations Global Compact, the Organisation for Economic Co-operation and Development (OECD) guidelines for multinational enterprises or ISO 26000 (the social responsibility guidance standard) when making the disclosures.

This is an important principle that has relevance for current review of the NFRD in terms of meeting the evolving needs of investors and requirements under the EU's sustainable finance regulatory regime.

Transparency and access to data and information

The transparency of data and information is fundamental to the success of sustainability-related reporting and non-financial disclosures. Yet caution is needed when it comes to striking the right balance between the appropriate level of useable data versus the risk of data overload.

There is a need to satisfy a diverse range of stakeholders in relation to a very diverse range of indicators[1], yet to do this within one useable report is a difficult challenge. One single standard-setter currently cannot satisfy the broad spectrum of sustainability-related requirements and preferences. More consultation is therefore needed on a multilateral basis with various international standard-setters, professional bodies and interested stakeholders before any standard is implemented.

Further, to achieve this level of transparency and availability, there will likely be associated costs – not only in gathering this data, but also in terms of the resourcing and expertise needed to fulfil the reporting requirements.

Therefore, a targeted approach might offer the best way forward, focussing in the first instance on core data and information needed in order to comply with the new EU sustainable finance regime. How costs will be borne and by whom is an important aspect to consider in seeking to strike the right balance of reporting requirements.

Careful consideration also needs to be given to where the source data for the reporting will be derived from, who will provide it and to whom it will be provided. Currently, investors need to use synthesised data that is not always available directly from the issuers.

Challenges arise in terms of persistent fragmentation and there are associated barriers and costs to gathering and reporting on this data. Considering the above, and in the interests of transparency towards all stakeholders, we recommend that the reported data be publicly available and reported via a common utility.

[1] Different stakeholders (e.g. investors, policy makers, governmental organisations, NGOs) may request ESG performance information under all of the 17 UN Sustainable Development goals.

We agree with and support the objective of providing meaningful, consistent, high quality ESG-related reporting from corporates. The lack of consistent and comparable data on sustainability-related risks and opportunities is currently a key challenge for financial participants.

We support greater standardisation on a sector specific basis as an enabler of data aggregation, digitisation and the beneficial analysis that this would bring. However, a balance needs to be struck in terms of the degree of prescriptiveness and flexibility – it cannot become a box ticking exercise as this would fail to provide a full understanding of a company's ESG profile.

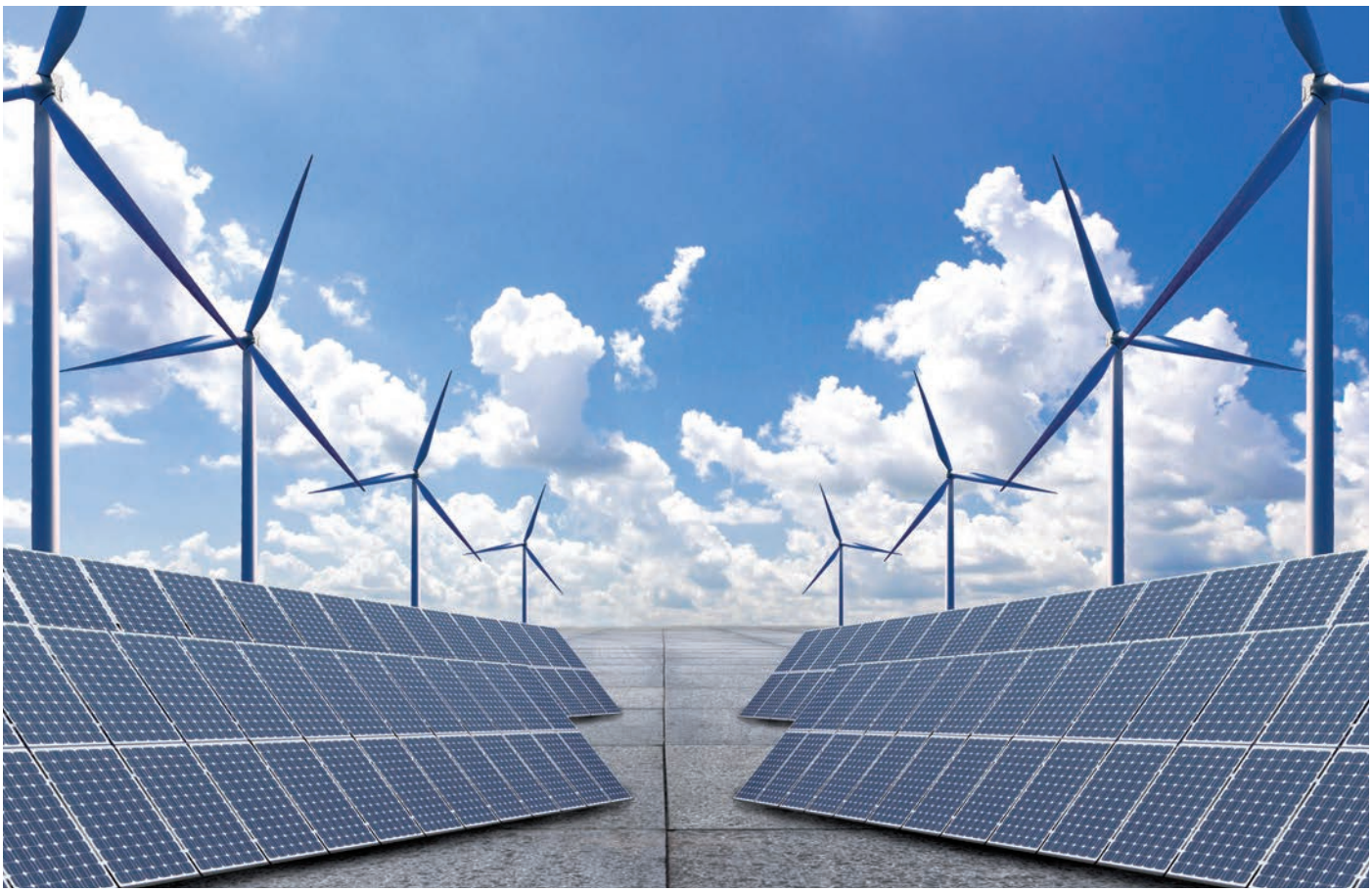
It is also essential that there is clarity in terms of what are mandatory disclosures and what disclosures could be considered best practices at a sector specific level. In that regard, we propose that the NFRD update focuses on mandatory information and KPIs needed to comply with the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation.

Within the investment management ecosystem, there are many parties that can operate under different models meaning that one size will not fit all. Therefore, further engagement with the investment community and professional bodies is fundamental to the success of any updated NFRD regime.

The NFRD regime should not operate in isolation of other global disclosure frameworks which are already in place (e.g. Sustainability Accounting Standards Board (SASB), the Task Force on Climate-related Financial Disclosures (TCFD), Global Reporting Initiatives (GRI), etc.).

Additionally, it cannot operate in isolation of existing regulations and disclosure requirements, including for example SFDR, UCITS and AIFMD reporting requirements and future amendments of these. In fact, this consultation and review of the current NFDR offers the Commission the opportunity to develop industry sector specific standards which draw the "best from the best" of existing standards that are already in place.

For the Commission to bring consistency to the non-financial reporting disclosures (including alignment with existing regulations) future consultation with professional bodies on an international basis is fundamental, as is the involvement of national accounting standard-setters, the European Supervisory Authorities, the European Central Bank, IOSCO and the OECD. The Commission could use the Platform on Sustainable Finance to assist in coordinating such an initiative.



The NFRD requires companies to disclose information "to the extent necessary for an understanding of the development, performance, position and impact of [the company's] activities."

This means companies should disclose not only how sustainability issues may affect the company, but also how the company affects society and the environment. This is the so-called double materiality perspective.

A clearly defined materiality framework by industry sector as it relates to non-financial information would aid in bringing clarity and consistency. It would also make the information and non-financial disclosures more relevant to the user as they would be disclosed in line with industry sector guidelines. This will also assist in distinguishing between what are the "nice to have" disclosures as opposed to the "must haves" at industry sector level.

It is acknowledged that this may be difficult to achieve, however, this is where consultation with a broad range of stakeholders on an international basis is essential (including investors, companies, asset managers and professional accounting bodies).

Third-party assurance

The provision of independent third-party assurance over the non-financial disclosures will enhance the integrity and credibility of the information disclosed. Currently there is no requirement for this non-financial information to be "audited" under the Accounting Directive. However, for assurance to be provided, data must be readily available and there needs to be clarity over which standard should be used to provide this assurance.

Overall, a specific assurance standard must be adopted for these non-financial disclosures and this should be on an international and also on an industry sector-specific basis. This would ensure consistency of the non-financial information and that specific industry sector requirements are reflected.

When it comes to determining the form and format of assurance reporting required, the professional accounting bodies and regulators need to be involved in discussions and transition may need to be made on a progressive basis.

Not all information which is included within the annual report and financial statements (potentially including the disclosure of ESG risks which have been deemed to be financially material) is covered by the statutory audit opinion.

Consideration should be given to the inclusion of this information in a separate report and if so, the contents of this separate report must be prescribed by new legislation. Such a report should be filed through the officially appointed mechanisms and finally should be signed and published on the same day as the annual report.

There are clear advantages to having the non-financial disclosures included within a separate report. A separate report will facilitate two different forms of assurance reporting. This will make it very transparent to the reader of the reports and related opinions in terms of the information which is being covered by each opinion.

This would also address concerns that information which is included within the appendix to the annual report is less important or unread. While there would be two separate reports, they can be circulated / published at the same time. As the annual report is inclusive of the financial statements which are essentially a historic based document, having two separate reports could alleviate concerns relating to the amalgamation of a historic based document (the financial statements) and a forward-looking document (the non-financial reporting disclosures).

However, having two reports may mean that there would be additional associated costs. It would also increase the administrative burden in terms of man hours and there could be concerns over the consistency of data and information between the annual report and the second non-financial reporting document (especially if there were two different third parties providing assurance opinions over each document).

Whilst it is important that clarity is provided on the location of the non-financial reporting disclosures, it is also critical that there is consistency and clarity provided as to the additional disclosures that will be required within the offering documents (KIIDs / prospectus, etc).

Given the wide number of interested stakeholders in this area, it is essential that prior to any decisions being made, that a further broad consultation with all relevant stakeholders is completed – and this is inclusive of international professional bodies and regulators internationally.

There is no doubt that this will be an area of debate and evolution for some time. We are supportive of the objective of the need to provide meaningful, consistent and high quality non-financial reporting in this area.

Coming soon…

Look out for our next publication in the area of non-financial reporting, which will consider the similarities and differences between some of the current international sustainable reporting standards (e.g. SASB, TCFD and GRI).

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