

## **NON-FINANCIAL INFORMATION, A TOOL TO ACHIEVE THE RECOVERY OBJECTIVES OF THE EUROPEAN UNION<sup>1</sup>**

(August 2020)

As part of the European Green Deal, the roadmap to endow the EU with a sustainable, fair and inclusive economy and meet climate neutrality targets by 2050, the European Commission announced a public consultation in February this year to review the non-financial reporting directive (NFRD). The deadline to participate was 11 June 2020.

Just over a year after the Directive came into force in the countries of the Union, users of non-financial information statements, regulators and supervisors have expressed the need to adjust certain contents in the regulation so that it complies with its objective: to provide all stakeholders with complete and homogeneous data on how a company's activities affect the environment and society, and how companies identify and deal with potential sustainability risks.

When we speak of interest groups, we put the accent on the participants of the capital markets. To comply with the obligations of disclosure of the environmental and social impacts of their investments and their financing operations they need to start from reliable, complete information that allows them to make decisions.

### **What does the directive require today?**

The NFRD (Directive 2014/95 / EU) amends the Accounting Directive (Directive 2013/34 / EU). It requires Entities of Public Interest with more than 500 employees, and large banks and insurance companies, whether listed or not, with more than 500 employees to include a non-financial information statement as part of their public information obligations beginning in 2018, for fiscal year 2017.

The NFRD requires companies to disclose information about their business model, policies, applied due diligence processes, results, risks and their management, and key performance indicators in five key aspects of sustainability. These aspects are the environment and climate change, social and employee issues, human rights, and corruption and bribery. Furthermore, companies must explain not only how sustainability issues can affect their business (risks and opportunities), but also how the company affects society and the environment. This is the so-called "double materiality".

In 2017, as required by the Directive, the Commission published *non-binding guidelines* for companies on how to disclose this non-financial information. In June 2019, as part of the Sustainable Finance Action Plan, the Commission published additional guidelines on reporting on risks and opportunities arising from climate change, which integrate the recommendations of the *Task Force on Climate-related Financial Disclosures* (TCFD).

### **The challenge of corporate reporting and information needs**

It is well known that the need for non-financial information from users, particularly investors, is increasing, and has been accelerated especially in the last five years. On the one hand it is to better understand the financial risks derived from climate crises we are facing, and on the other hand it is due to the pressure received to increase the number of financial products that need to integrate ESG (*environmental, social and governance*) information from the companies in which they invest or that they finance.

To this, other regulatory developments are added such as the Regulation on the disclosure of information related to sustainability in the financial services sector (Regulation (EU) 2019/2088), and the development of a classification system for sustainable economic activities (better known as “the EU taxonomy”). Financial entities may meet the objectives if more and better non-financial information is available from the investee companies.

Finally, for those companies under the scope of the NFRD, the EU taxonomy will require them to disclose through economic indicators such as their income, CAPEX, or OPEX, which activities are sustainable according to the taxonomy.

### **The reason for the European Commission’s consultation**

The previous public consultation on non-financial reporting confirmed that it currently does not adequately meet the needs of users. In particular, it was deduced from the results that there is a lack of comparability and reliability, that there is relevant information that is not communicated by the companies and that the companies also publish non-relevant information. Additionally, companies face uncertainty and complexity when deciding what non-financial information to publish and how to report that information. In the case of companies in the financial sector, this complexity is accentuated by the different additional disclosure requirements on products and the impact of their investments and financing operations, mentioned above.

In December 2019, in its conclusions on capital markets, the European Council underlined the importance of having reliable, comparable and relevant information on sustainability risks, opportunities and impacts, and asked the Commission to consider the possibility of developing a reporting standard.

In 2020, during its communication on the European Green Deal, the Commission committed to the revision of the NFRD as part of the strategy to strengthen the foundations of sustainable investment. To meet the objectives of the European Green Deal would require the mobilization of a minimum of a billion Euros over the coming decade<sup>2</sup> in all sectors of the economy, the bulk of which will come from the private sector. In this sense, the revision of the NFRD is part of the effort to expand sustainable finance by improving transparency.

Furthermore, the European Green Deal also underlined that sustainability should be broadly integrated into policies and the corporate governance of companies, with a more strategic and long-term vision. In future developments we can expect a greater focus on the protection of natural capital and biodiversity.

### **What are the aspects collected in the consultation?**

The Commission intends to obtain input on the following aspects that present the difficulties mentioned above

- Quality and scope of non-financial information, especially regarding the incorporation of additional categories of non-financial information that companies should communicate.
- Standardization of information for which it is proposed that companies use common and binding standards.
- Definition of the principle of materiality in the context of non-financial information and sustainability.

- Verification or assurance of reports, an aspect that is presently applied unevenly in different countries.
- Digitization and accessibility of information.
- Structure and location of the non-financial information statement, which is published together with the management report or separately.
- Scope and extension of the area of application of the NFRD to other types of entities, such as large unlisted companies or subsidiaries of companies subject to the regulation.

### **EFFAS's contribution to the consultation**

EFFAS, as a representative of the European financial and non-financial analyst associations participated in the consultation and the main contributions to the challenges identified by the Commission are summarized below.

Additional elements of non-financial information disclosure to include in the next NFRD review, given its relevance to the risk and opportunity management of companies and funders, should include (1) that companies disclose their medium and long-term value creation strategies; (2) climate risks, deforestation and biodiversity; and (3) the management of intangibles related to the human factor of companies, such as relational, organizational and the human capital.

It would be necessary to define the indicators that allow a clear understanding of how companies deal with these risks to sustainability and show improvement in their performance, up to long-term time horizons, 2050 in the case of natural capital and biodiversity conservation.

In addition, EFFAS points out the need to incorporate sectoral disclosure standards, supporting a greater application of current standards such as the IIRC<sup>3</sup> and SASB<sup>4</sup> and in second place, the GRI<sup>5</sup>, recognizing that the application of these together with other additional standards such as the EFFAS's performance indicators, the WICI<sup>6</sup> framework for reporting intangibles, the Natural and Social Capital Protocol, the Climate Standards Board and more exhaustively the TCFD, would improve the quality of the information.

Regarding the application of regulations in medium and small companies EFFAS suggests that there can be a specific simplified version of the previous standard of an obligatory nature, but which is less demanding. They also suggest that the NFRD can contemplate greater depth and knowledge of the financial field to ensure connectivity and integration of financial and non-financial information.

Regarding the stakeholders involved in the development of the new standard, they point out that the investors, as well as the companies that prepare the non-financial information statements, should have the greatest involvement, followed in importance by auditors and accountants, organizations from civil society and the Academy, and thirdly from other interest groups such as environmental experts, and financial and non-financial analysts.

Regarding the regulators whose involvement would be necessary, they point to the European Securities Markets Authority, the Banking, Insurance and Pensions Authority, the European Central Bank, as well as the European Environment Agency and the Commission's working group on Sustainable finance. They suggest that other stakeholders to be involved could be EFFAS and WICI Europe.

Regarding the relevance of the definition of materiality established in article 2 (16) of the Accounting Directive to understand what information is necessary to understand the

development of a company and its performance as well as its impacts on the environment and society, a clearer definition in both these senses is considered very important.

EFFAS understands that materiality must be considered within the concept of value creation. Materiality must always refer to the specificity of the sector of activity, the specificity of the Company's business, and also refer to megatrends such as climate change, deforestation, the depletion of biodiversity, growing inequality, and tax evasion amongst others. An additional aspect to discuss is the understanding of materiality in the short and long term, its periodic updating, the governance of reporting and the involvement of the board of directors in the reporting process. The definition of materiality must also consider the controversies of the reporting company.

On the reliability of the information, EFFAS maintains that the current difference between the processes of financial auditing and assurance of non-financial information should not be so wide. They suggest that the assurance, in the future, should be “reasonable” and not “limited”, and that the verifier should provide insight into the company's non-financial risk factors, using a common assurance standard. Also, auditors should have an ESG rating and the EU Commission should encourage the publication of the new rating from the IAASB.

The digitization of information should also be considered to facilitate better access to useful information to stakeholders and especially to capital markets. Regarding the publication of the information separately from the financial report, EFFAS proposes that the requirement to publish it in a single document could be considered.

Finally, in terms of the scope of the standard, it is proposed that all companies participating in regulated financial markets and companies that operate in Europe but that are listed outside Europe are also subject to application of the NFRD, as well as eliminating the exemption for subsidiaries whose parent company is currently reporting under the standard.

In conclusion, these contributions from EFFAS together with those of all the participants in the consultation, will constitute the future contents of the Directive that we will have to attend to and that will guide the steps of corporate transparency, the improvement in decision-making in the capital markets and they will bring us closer to the objectives of the European Union to achieve a more sustainable, fair and inclusive economy.

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<sup>1</sup> This is a translation from Spanish. The original title is *La Información No Financiera, Herramienta para el Cumplimiento de los Objetivos de Recuperación de la Unión Europea*

<sup>2</sup> [https://ec.europa.eu/regional\\_policy/es/newsroom/news/2020/01/14-01-2020-financing-the-green-transition-the-european-green-deal-investment-plan-and-just-transition-mechanism](https://ec.europa.eu/regional_policy/es/newsroom/news/2020/01/14-01-2020-financing-the-green-transition-the-european-green-deal-investment-plan-and-just-transition-mechanism)

<sup>3</sup> IIRC: International Integrated Reporting Council

<sup>4</sup> SASB: Sustainability Accounting Standards Board

<sup>5</sup> GRI: Global Reporting Initiative

<sup>6</sup> WICI: World Intellectual Capital/Assets Initiative