REVISION OF THE NON-FINANCIAL INFORMATION REPORTING DIRECTIVE (NFRD)

Corporate transparency on sustainability issues is a prerequisite to enable financial market actors to properly assess the long-term value creation of companies and their management of sustainability risks.

Finance for Tomorrow is the branch of Paris EUROPLACE launched in 2017 to make green and sustainable finance a driving force in developing the Paris Financial Centre and positioning Paris as a leading financial hub on these issues.

With more than 80 members, it brings together private, public and institutional players as well as think tanks, NGO's and international observers, and can provide a legitimate and experienced-based contribution to the Commission's work on the revision of the 2014 Directive.

EXECUTIVE SUMMARY:

The EU level appears to be relevant to take the lead on the standardization of extra-financial disclosures.

In this perspective, **we strongly support the idea to replace the current directive by a regulation**, with the ambition to implement a recognized common European non-financial reporting standard, able to become a global standard.

We agree that the different problems identified by the Commission seriously prevent the current framework to reach its objectives. While amending Non-Financial Reporting Directive (NFRD), the main purpose should be to improve readability and operational character of the disclosures, for the benefit both of the preparers and all the stakeholders. Such an improvement should in parallel avoid companies to have to comply with several standards when they operate worldwide, but also help them to use non-financial reporting obligations as a steering tool.

In this position paper, we make five recommendations to go towards a simplified but ambitious standard under EU leadership:

1. **To converge towards the widely adopted ESG classification;**
2. **To safeguard the double-materiality approach;**
3. **To simplify mandatory obligations of big companies;**
4. **To introduce a simplified voluntary framework for SMEs;**
5. **To promote international alignment.**

We make two further recommendations related to the reporting itself:

6. **To implement a two dimensions report;**
7. **To give non-financial reporting the same value as financial one.**

BACKGROUND:

Building on HLEG's work, the European Commission released in March 2018 its Action Plan for Financing Sustainable Growth, specifying EU objectives to:

1. reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
2. manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
3. foster transparency and long-termism in financial and economic activity.

In order to reach the third objective, the plan defined various initiatives aiming at "strengthening sustainability disclosure and accounting rule-making" (action 9 of the action plan), and "fostering sustainable corporate governance and attenuating short-termism in capital markets" (action 10 of the action plan).

In 2014, the EU adopted the Non-Financial Reporting Directive (Directive 2014/95/EU), an amendment to the Accounting Directive (Directive 2013/34/EU), which required, as from financial year 2017, certain large companies to include a non- financial statement as part of their annual public reporting obligations. To complete this legislation, the Commission published in July 2017 non-binding guidelines for companies on how to report non-financial information, complemented in June 2019 by additional non-binding guidelines on reporting climate-related information.

In the European Green Deal communication published in December 2019, the European Commission made a commitment to review the Non-Financial Reporting Directive (NFRD) by the end of 2020.

This initiative aims to address the following problems identified by the Commission:

1. There is inadequate publicly available information about how non-financial issues, and sustainability issues in particular, impact companies, and about how companies themselves impact society and the environment : reported non-financial information is not sufficiently comparable or reliable, sometimes insufficient or on the contrary irrelevant, and soften hard to find even when it is reported.
2. Companies face uncertainty and complexity when deciding what non-financial information to report, and how and where to report such information, incurring unnecessary and avoidable costs. In the case of some financial sector companies, this complexity may also arise from different disclosure requirements contained in different pieces of EU legislation.
3. Companies are under pressure to respond to additional demands for non-financial information from sustainability rating agencies, data providers and civil society, irrespective of the information that they publish as a result of the NFRD.

For the purpose of this revision, the Commission launched a consultation to gather data and stakeholder views for the review of the Non- Financial Reporting Directive.

A HARMONISED NON-FINANCIAL REPORTING FRAMEWORK UNDER EU LEADERSHIP

The goal of non-financial reporting is *"to provide all corporate stakeholders with high-quality extra-financial information to assess their contribution to sustainable economic, financial and social development"* (de Cambourg report).

From an institutional perspective, the EU disclosure framework (currently the NFRD and its non-binding guidelines) is supposed to help companies, project promoters, investors and issuers plan and report the transition to an economy that is consistent with the EU's environmental objectives.

The standardization, defined as the design of a harmonized global framework, required for extra-financial information must be granted the necessary legitimacy by development and adoption in the public sphere.

And with its Common Market, the EU level appears to be the most relevant for the standardization of extra-financial disclosures, and it's not useful to involve national authorities, except on the aspects which could fall under the jurisdiction of Member States (very few).

For this same reason, **we strongly support the idea to replace the current directive by a regulation**, with the ambition to implement a true common European non-financial reporting standard.

We agree that the different problems identified by the Commission (hereabove) seriously prevent this regulation to reach these objectives and we make five recommendations to go towards a more efficient framework:

1. To converge towards the widely adopted ESG classification:

The NFRD currently identifies four sustainability issues: environment, social and employee issues, human rights, and bribery and corruption.

To become a recognized standard, it could make sense to use the widely adopted criteria of Environment (including climate AND Paris Agreement targets), Social (covering current social, employee issues, and human rights), and Governance (including bribery and corruption, but extended to tax policy issues and all other governance matters).

Intangible assets are by nature already largely embedded into non-financial matters, but they could be developed further.

Such an approach would give way to the suppression of many parallel regulations, both at EU and Member States levels, as they are overlaps, missing pieces and need to streamline.

It would also help the very various stakeholders to find more easily the information needed to make a proper ESG analysis of the corporate or the financial institutions subject to the reporting.

The EU taxonomy regulation is (and/or will be) a useful tool to help investors, companies, issuers and project promoters plan to: (i) identify investment opportunities which meet a high standard of sustainability; (ii) construct taxonomy-aligned portfolios and monitor their impact; (iii) strengthen and enable more focused dialogue between investors and companies on investment impact; (iv) support communication between fund managers and asset owners, particularly resource-constrained asset owners that may struggle to develop deep environmental expertise.

Taxonomy is definitely a key piece of EU sustainable finance framework, which is supposed at some stage to go beyond pure climate/environmental aspects to include, at the end S and G criteria.

But the scope of the data to be disclosed is much larger than that, with the aim to help investors and other stakeholders (consumers, public authorities, citizens, NGOs …) to understand how ESG issues impact the company's development, performance, position AND how its activities impact environment and the society.

2. To safeguard the double-materiality approach:

According to the Non-Financial Reporting Directive, a company is required to disclose non-financial information to the extent that such information is *"necessary for an understanding of the company's development, performance, position AND impact of its activities"*

These two risk perspectives already overlap in some cases and are increasingly likely to do so in the future. As markets and public policies evolve in response to climate change, the positive and/or negative impacts of a company on the climate will increasingly translate into business opportunities and/or risks that are financially material. The same thoughts could certainly apply to other ESG aspects.

A common standard should clearly advocate this double-materiality approach, which is in our mind in line with European values.

In this respect, European companies should be required to disclose in their non-financial reporting how they define materiality, and which processes they have put in place to identify their material environmental, social and governance (ESG) issues.

3. To simplify mandatory obligations of big companies:

A very simple way to clarify obligations of big companies would be to transform the non-binding guidelines of July 2017 and June 2019 into a mandatory framework, in terms of disclosure of non-financial information (i) on business models, (ii) on policies and due diligence processes, (iii) on outcomes,(iv) on principal risks and their management and (v) on Key Performance Indicators.

In parallel, this mandatory framework should be extended to all companies operating in the EU, listed or not (not only public interest entities) with more than 500 employees. Requiring all companies established in the EU with more than 500 employees would ensure a level playing field in the companies' non-financial disclosures.

A particular attention should be given to financial institutions, which are both user and preparer of information and are also subject to the disclosure regulation of November 27, 2019 on sustainability-related disclosures in the financial sector

The current regime on both listed and non-listed companies' disclosure obligation of financial information remains adequate and should not be changed under the NFRD review. Also, it's probably not a good idea to remove the exemption for companies that are subsidiaries of a parent company that reports non-financial information at group level in accordance with the NFRD, as their ESG performances are already reported at group level.

4. To introduce a simplified voluntary framework for SMEs:

SMEs belonging to the supply chains of big companies are already constrained by the rules applied to their clients. Those not part of those supply chains have a clear interest to adopt proportionate standards in that field. The objective should be also not to exclude middle size and small entities from investment universes.

For this reason, a set of ESG standards dedicated to companies with less than 500 employees (whether they are listed or not) should be introduced to allow them to use a simplified voluntary non-financial information reporting framework.

Obviously, this specific reporting framework should be proportionate to the specific situation of SMEs, to incentivize them to report on their respective ESG challenges.

5. To promote international alignment:

A common European non-financial reporting standard should necessarily, from the beginning, be in line with the Financial Stability Board's Task Force on Climate-related Financial Disclosure (TCFD) incorporated in the revised non-binding guidelines issued in June 2019. It could eventually take into account some principles and content of the UN Guiding Principles Reporting Framework, the Carbon Disclosure Project (CDP) approach and, to a lesser extent, the Global Reporting Initiative (GRI).

We want also to point out the importance of the Sustainable Development Goals (SDG), which became an international standard for investors, corporates and public authorities, allowing them to frame their investment and business strategy in line with United Nations climate and development goals. Some investing companies have already integrated an SDG evaluation framework in their ESG due diligence and performance monitoring processes. And linkages and complementarity between the NFRD and the SDG framework can easily be evidenced, making sense to leverage on the latter to build the European non-financial reporting standard.

In parallel of this standardisation, the EU should advocate the emergence of a generally accepted international sustainability accounting standard.

While absolutely necessary, harmonization and/or rationalization of reporting standards is a long-term effort and ultimately will work best if accounting standard setters do take on the topic in their mandates. The G20, FSB (building on the efforts of the TCFD and other industry-driven initiatives), accounting standards boards (IASB and FASB) and those initiatives involved in the Corporate Reporting Dialogue to promote alignment and consolidation in the area of sustainability reporting should be encouraged.

A SIMPLIFIED FORMAT AT THE SAME LEVEL AS FINANCIAL REPORTING

At the "preparer" level, striking a balance between materiality and comprehensive disclosure with the right format is a challenging task.

Actually, companies face a complicated dilemma to solve:

- On the one hand, they are asked to be concise in focusing on their main issues, broken down in terms of risks and opportunities, policies, action plans, results and performance indicators. This is in our understanding the spirit of the current directive and the guidelines linked to it (which is itself inspired by the principles supported by integrated thinking).
- On the other hand, they are asked by most of the stakeholders (investors, rating agencies, NGOs …) to go beyond, providing very detailed data to be used as an input for analysis.

On the top of that, the non-financial reporting is generally not recognized at the same level as financial reporting. Choosing a clear approach about how to align ESG/non-financial reporting with the principles of financial reporting (although not the content, of course) could facilitate other decisions.

That's why we make two further recommendations regarding the reporting itself:

6. To implement a two dimensions report:

To address the dilemma, one solution would be to have a two dimensions report.

One part would be of a strategic nature, with both a general dimension and a sector-specific one. Those elements, including scenarios, forward-looking information, story-telling in some way, must be disclosed publicly in the perspective of a double-materiality approach with various stakeholders (investors, but also consumers, public authorities, citizens, NGOs…). Eventually, some of them can be disclosed to supervisors only.

One other part, much more granular, would be based on a standard format and a detailed taxonomy, to be as "machine readable" as possible, with the possibility to update data on a regular basis between two annual reportings.

It would answer to the need of the investment community to have as many machine-readable data, while answering also to the issuers, who think that there is a risk of misinterpretations/misunderstandings of data which, by definition, are very qualitative.

This second part of the report would be improved step by step, with the development of artificial intelligence.

7. **To give non-financial reporting the same value as financial one:**

ESG issues, or firm's responses to those issues, could impact the value of companies' assets and prospective profits directly, or indirectly because of changes to how their businesses are operated.

It is essential to afford to non-financial reporting a comparable status to that of accounting and financial disclosures and also guarantee its relevance and quality in the same way. This general principle helps to deal with many different issues as it will shape approach to questions such as location and timing of disclosures, assurance requirements etc…

Following this principle, ESG disclosure should be held to similar assurance requirements as other disclosures (internal/Board approval, audit). Then, the fact to have non-financial information assured should be mandatory, the assured company keeping flexibility in the choice of the type of assurance (reasonable or limited) to be chosen. It will give non-financial reporting standards a legal level equivalent to that recognized in accounting and financial standards.

Reasonable assurance may be chosen on performance against a selection of strategic KPIs and limited assurance on others or on the rest of the report. However, it must be clear to the user what has and has not been assured, and what type of assurance is being given to different indicators.

At present, companies publish detailed ESG data and information in different publications and in non-standard formats: Annual reports, Sustainability reports, Websites.

TCFD rightly recommends integrating disclosures into "annual financial filings". The NFRD should not allow anymore Member States to permit companies to publish their non-financial statement in a separate report. A company subject to the NFRD should publish these disclosures in its management report, in line with TCFD recommendations.

Following the same principle as hereabove, the non-financial reporting should definitely be part of the management report of the company in all the EU jurisdiction.

Obviously, within the management report, it will make sense to separate non-financial and corporate governance statements from financial statements.