Web-roundtable: Development of EU standards as part of the reform of the EU Non-Financial Reporting Directive

Co-organised by Frank Bold, coordinator of the Alliance for Corporate Transparency and the World Benchmarking Alliance on June 29, 2020

Summary of discussions

The web-roundtable was convened to address key issues and pressing questions around the development of EU non-financial reporting standards and how they should interact with existing frameworks and the reform of the EU Non-Financial Reporting Directive (NFRD). The online event gathered 44 participants, representing the interests of the investor, accountant, regulatory, civil society and reporting standards communities.

Background

Following the presentation of the Green Deal in December 2019, the European Commission initiated the reform of the EU Non-Financial Reporting Directive (NFRD) with the objective to improve quality, consistency, comparability, as well as accessibility of critical information on sustainability disclosed by companies. The first step in this process was a public consultation, which was concluded in June 2020.

Simultaneously, European Commission's Executive Vice-President Valdis Dombrovskis announced the development of non-financial reporting standards to accompany and specify the legislation and invited the European Financial Reporting Advisory Group (EFRAG) to start preparatory work and deliver its advice to the EU Commission by the end of 2020 on the structure and priorities for these standards.

The online discussion was organised in the following three sessions in order to provide early input in the above mentioned process:

- Session 1: What can EU standards bring to the table and how should they interact with EU policy processes and objectives?
- Session 2. Mandatory nature of the standards vis-a-vis materiality
- Session 3. Priorities for standardisation

The debate was held under Chatham House rules, therefore this summary will not identify specific organisations or participants but rather reflect the issues discussed and different points of view expressed by speaker and participants. The event was connected to a previous public webinar on the reform of the EU NFRD held in May (recording available here).

Session 1: What can EU standards bring to the table and how should they interact with EU policy processes and objectives?

- The reform of the NFRD and the development of EU reporting standards are indispensable for the success of the EU Sustainable Finance Agenda and as such are essential to the European Green Deal.
- It is important to ensure there is coherence between what investors need to report and the information that companies are mandated to provide. The EU reporting standards should ensure there is a proper connection between the EU taxonomy (which is defining specific criteria and thresholds for what are sustainable investments in terms of financial and economic activities, including do-no harm provisions) and the development of technical standards for investors' disclosures (which will require financial market actors to report on how they integrate ESG issues). EU standards will ensure the whole information chain is complete. However, It was stressed that these three different

strands of work (corporate reporting, investor disclosure and classification of sustainability activities) have some inherent differences in scope, objective and stakeholders depending on the information. In terms of timing, there is an opportunity for the EU NFRD to catch up and advance on the social, human rights or anti-corruption areas.

- Simultaneously, the EU is looking at implementing policies to focus on incorporating human rights and environmental due diligence and sustainable corporate governance. The European Commission (DG Justice) is expected to put forward a legislative proposal in 2021 and the European Parliament is working on two own initiative reports looking into these two topics. EU reporting standards will have to equally reflect these developments, both in content and applicability. With regard to the latter, it was highlighted that the comply or explain principle would need to be revisited.
- Given that investors are active globally, global standards are needed. However, such global standards may not come in due time and therefore the EU should lead this process by adopting its own standards first. The process of global standardisation will be significantly sped up by the "EU effect". ESG issues are financially material and should be integrated into IFRS standards- GRI, SASB provide an important baseline towards a globally harmonised system.
- There is a sense of urgency as the past decade has not shown enough progress, with companies disclosing more but not necessarily better. Reliable, meaningful and comparable sustainability data is crucial to redirect capital to support sustainable activities, and for regulators, supervisors and civil society to assess the progress and non-compliance of laggards. We do not have another 10 years to test and fail.
- EU standards should reflect public objectives, such as the goals of the Paris Agreement, UN Sustainable Development Goals, and UN Guiding Principles on Business and Human Rights, to provide a meaningful data framework. Clarifying key public policy objectives, targets and recommendations on how to reach these common sustainability goals is essential to capture impact. Furthermore, the development of NFR standards provides a unique opportunity to track and monitor if we're achieving the objectives set in the Green Deal.
- The EU standards should build on existing standards. The process of developing EU standards should assess the needs for clarification and potential gaps (especially with regard to public policy objectives), which can be achieved in a way that does not undermine voluntary standards or excludes global applicability.
- The standards should be developed on a continuous basis to allow changes and emerging public objectives and metrics to be incorporated.

Session 2. Mandatory nature of the standards vis-a-vis materiality

- The double materiality approach adopted in the EU, reflecting the risks that sustainability related matters pose to the company, as well as the impacts that businesses have on people and the planet should be the main principle for corporate reporting and by extension for the application of EU standards.
- Disclosing the 'materiality' or risk assessment process has benefits to enhance transparency. Without a description of the process, it will be unclear why certain risks have been determined to be salient and why others have been discarded as secondary / irrelevant. Making a description of the process compulsory would help companies to systematise their approach and provide a framework for them to do so. Many companies are struggling with the notion of due diligence / risk assessment / materiality and what is expected in practice. Participants also noted that the comply or explain mechanism should shed light to companies that choose to not report on a specific matter as outlined in the NFRD and the standards (save for mandatory information).
- Participants highlighted that NFRD and EU standards should clarify how the principle of double materiality should be applied in practice by companies for different thematic issues. This is particularly important in the context of human rights, to ensure that disclosure of material human rights risks are seen through the lens of the most severe impacts on people and that this should be mandatory. It is noted that the audience and time horizons of financial and non-financial materiality are different but complementarity and that, from an environmental perspective, materiality needs to be linked to scientific limits of natural resources.
- There are some universally applicable human rights indicators, which should be clarified by the standards (such as percentage of workforce that are unionized, on temporary contracts, or medium vs top pay), without setting an extensive set of concrete indicators which will likely lead to immaterial disclosures, because appropriate indicators

will often depend on the context and will need to be set on individual basis. It was stressed that a high proportion of indicators used by companies are focused on activities and processes. However information on the outcomes or the impact (i.e result of the implementation of policies) is scarce. It was recommended that standards require disclosure of targets that focus on outcomes linked to the identification of the most severe risks on people and communities.

- The NFRD and EU standards should also clarify which fundamental issues are considered universally material. It was noted that the government is a key stakeholder that companies need to take into account when carrying out their materiality determination process. The public policy objectives should be therefore understood as universal issues for all companies (i.e climate change, tax, anti-corruption), and these universal issues should be clarified in the NFRD. The standards should then set out mandatory sets of information applicable to all companies and companies in different sectors. Standards could further specify red flags that should trigger reporting on particular aspects addressed in the standards.

Session 3. Priorities for standardisation

- Participants suggested that the key role of the standards should be to clarify key sustainability issues and qualitative and quantitative information that are relevant for companies in a specific sector (i.e climate change for Oil and Gas companies or supply chain management for the Textile industry). Furthermore, it was suggested that the NFR standards could build on several degrees of requirement, mandating certain issues in some sectors, while maintaining them optional for others. This could be achieved through a combination of Level 1 mandatory and Level 2 recommended requirements similar to the method used in the report of the Technical Expert Group on Sustainable Finance. .
- Certain areas, such as climate change, have widely accepted defined criteria stemming from scientific and/or governmental agreements. Other areas which are equally relevant to understand the performance and impact of companies on Environmental, Social and Governance issues, such as biodiversity or supply chain transparency, have been developed more recently. The development of EU standards provide an opportunity to further define and increase consensus on these areas while striking the right balance between complexity and clarity, as well as the relation between materiality determination and mandatory disclosures
- The major gap that standards should focus on concerns reporting on transition targets with regard to climate change and use of natural resources neutrality, including specifying units of measurement, timelines and information on strategies.
- In the area of human rights, the recommended priorities included human rights due diligence (in particular with regard to complex supply chains), board oversight on human rights issues, qualitative requirements for outcome-oriented targets (as discussed in Session 2), effective grievance mechanism and supply chain transparency.
- It was further highlighted that biodiversity is a priority area that urgently requires clarification.
- The priority governance topics suggested by the participants included sustainability strategies with regard to planetary boundaries, board oversight over such strategies and sustainability risks and opportunities, remuneration of executive management and procurement.
- Several participants stressed a need to increase transparency concerning tax payments.
- Concerning business models, it was suggested that standards should strengthen the integration of financial and non-financial risks, carefully considering the integration/connection between sections, and help companies focus on long-term value creation considering their multiple capitals.
- It was also suggested that standards are required for disclosure of physical asset level data to accompany companies' reporting on risks and impacts.
- It was pointed out that standards are indispensable for digitalisation of ESG data, which itself is of crucial importance to investors. The announcement of the plans to create an EU repository that would centralise and enable public access to the sustainability and financial disclosures of companies is welcome in this regard.
- From a company's perspective, it was deemed important that standards bring clarity to the current very complex landscape provided by comprehensive voluntary standards. The standards should specify priorities and mandatory issues and KPIs, rather than offering overly complex standards and relying on companies to determine what is material, which is very challenging, especially for SMEs.