Project on preparatory work for the elaboration of possible EU non-financial reporting standards

Reflections on the Project Task Force Progress Report from Frank Bold and the Investor Alliance for Human Rights

Frank Bold, coordinator of the Alliance for Corporate Transparency, and the Investor Alliance for Human Rights welcome the European Commission's commitment to explore the development of mandatory EU standards to accompany the reform of the EU Non-Financial Reporting Directive, contributing to the improvement of the EU legal framework around corporate sustainability reporting.

The Project Task Force on EU standards, hosted by the EU Corporate Reporting Lab under EFRAG, is carrying out critical preparatory work on the matter. The research of the Alliance for Corporate Transparency underscores the importance of the main findings outlined in the Task Force interim report. In particular, through the assessment of the sustainability disclosures of 1000 companies in 2019, and the recently published analysis of the latest climate/environmental disclosures of 300 European companies from sectors and regions critical to European decarbonisation plans, the research of the Alliance highlights the need to clarify and standardise sustainability reporting requirements to improve the quality and relevance of sustainability disclosure.

As the Task Force moves into its next phase, **we would like to encourage it to provide recommendations on the following matters** (please also note that in Part II, Frank Bold provides more detailed reactions to specific points of the report):

1. Alignment of the future EU standards with human rights and environmental due diligence

Firstly, due diligence provides a methodology for the determination of materiality regarding impact on people and the environment, that is, for the impact side of double materiality. Secondly, the EU NFRD does not specify in enough detail what needs to be reported on the application of human rights due diligence, while existing reporting standards present contradictory instructions for companies, often reducing the matter to standardised KPIs that fail to convey meaningful and reliable information. As a result, the state of current reporting practices is very poor. It is therefore critical that EU standards clarify key qualitative criteria covering due diligence implementation, engagement of impacted stakeholders, salient issues, targets tied to the prevention/mitigation of identified issues and impacts, supported by a carefully chosen set of quantitative indicators.

2. Double-materiality

The materiality of individual topics should be determined through an identification of financial (or pre-financial) risks and severe impacts on people and the environment. Both aspects of this double materiality analysis should be carried out independently, yet they are clearly connected, as outlined in the EU NFRD, in the European Commission's guidance and the interim report of the Project Task Force. The nature of the interaction between the two materiality dimensions, however, differs significantly across individual social and environmental topics. In climate matters, there is a strong overlap between the two perspectives which results in a greater emphasis on financial risk, in particular with respect to the alignment with public decarbonisation goals; for human rights matters such an overlap can be less clear and thus should not be a filter to exclude salient human rights issues based on the consideration of a company's connection to severe impacts on people. A double-materiality assessment should be performed for each topic individually, based on the analysis of the company's business model, risks and impacts, using specific requirements relevant for each issue. Future EU standards should therefore clarify the principles and transparency requirements for the determination of materiality on a thematic basis. An attempt to produce a uniform standard for the determination of materiality applicable to all topics and themes would reinforce confusion.

3. Principles for quality of information

As highlighted by the research of the Alliance for Corporate Transparency, while companies disclose general and often vague policy commitments on sustainability issues, a majority of them fail to provide specific information on the implementation of such policies, able to convey a company's seriousness to manage impacts and risks, as well as their plans and objectives. To overcome these shortcomings, EU standards need to:

- Specify detailed principles/criteria for quality of information related to due diligence processes;
- Specify principles/criteria for the quality of the disclosure of forward-looking information with a focus on setting targets and disclosure against them and outcomes of policies and processes.This is applicable in general, but particularly needed for issues for which standardising KPIs is not possible;
- Where valid quantitative KPIs are included in standards, clarity on the calculation methodologies to be applied. This is essential to provide users of the information with an understanding of a company's progress over time.

4. Integration in corporate strategy

Information on how companies integrate the results of their materiality determination into corporate strategies is of critical importance. Furthermore, the European Commission plans to present a legislative proposal strengthening directors' duties in this regard. As a consequence, in addition to much needed thematic standards and related sector specifications, EU standards should include a sector-agnostic standard clarifying what information should be provided on how the outcomes of the materiality determination are reflected in targets and objectives, and how these are integrated in corporate strategy as a whole. This is particularly important for issues that can only be tackled through changes to a company's business model. Such a standard should not be confused with transparency on the process of materiality determination, which we suggest should be addressed directly in the thematic standards for individual topics, where necessary.

Analysis provided by:

Frank Bold is a public interest law organisation working to solve social and environmental problems. The organisation coordinates the Alliance for Corporate Transparency, an initiative that has assessed the human rights and environmental reporting of 1000 EU companies in order to provide evidence-based recommendations and support the development of the EU legal framework on sustainability reporting. Since 2006, Frank Bold is member of the Steering Committee at the European Coalition for Corporate Justice (ECCJ), an initiative of over 260 organisations, to promote a new accountability framework of corporations for their social and environmental impacts worldwide.

The Investor Alliance for Human Rights an initiative of the Interfaith Center on Corporate Responsibility, is a collective action platform for responsible investment and is grounded in respect for people's fundamental rights. It is a member-based initiative focusing on investor responsibility to respect human rights, corporate engagements that drive responsible business conduct and standard-setting activities that create an environment for robust business and human rights policies.

See Annex for more reactions to specific points of the interim report

Annex: Reactions to specific points of the interim report

As well as encouraging the provision of detailed recommendations on the issues outlined above, Frank Bold would like to stress the relevance of specific points outlined in the report and offer our reflections. All references to the Alliance for Corporate Transparency's research refer to the 2019 analysis of 1000 EU companies, unless we explicitly refer to the newer analysis (from 2020) of the climate disclosures of 300 companies.

Implications for Level 1 changes

Content point 14 of interim report: From a general standpoint, while concentrating on potential EU standard-setting activities ("Level 2"), the Task Force may put the emphasis on certain assessment points that are or could be of a legislative nature ("Level 1"). When this is the case the purpose is only to indicate the importance of those points and of the related policy and framework options as a foundation for the development of a robust set of standards.

Comments: We agree with the PTF's assessment on this. More specifically, Level 1 is required to:

- Firmly embed and clarify the double materiality perspective;
- Bring clarity to the key categories of information and their interconnectivity; mandate transparency regarding the forward-looking dimension of disclosure (targets), as well as governance, but also the integration of a company's materiality determination results in the overall company strategy (linked to point 58 of the interim report "extent of reporting specific targets to measure progress is limited (e.g. failure to report on targets on climate change, and measurement of actions to manage human right risks)"). As shown by the research of the Alliance for Corporate Transparency, companies fail to report on targets (e.g. only 36.2% out of 1000 companies report on climate targets). Similarly, while 56.6% of companies report on human rights risks, only 3.6% disclose KPIs or examples documenting effective management;
- Specify key EU objectives that need to be reflected in standards (e.g. HRDD, EU climate goals, etc.).

Diversity of practices and standards
(related to the work of workstreams A2 and A6)

Content point 28 of interim report (summary): Of all the KPIs / data points of a non-financial nature inventoried by the PTF, the vast majority tends to concentrate on negative impacts rather than potential positive impacts. The notion of "positive impacts" remains vague and does not correspond to standardised language across different stakeholders and initiatives. In addition, some initiatives focus on intangible indicators (but mostly under sector or experimental approaches) in order to concentrate on what is not currently captured by financial information.

Comments: The lack of reporting on positive impacts is due to the nature of the problem when it comes to business impacts on environment and social issues. Setting aside general positive impacts such as provision of employment and consumer welfare, in sustainability matters, negative impacts dominate over positive ones. Furthermore, it is not so easy to standardise positive impacts; such standardisation could have an undesired effect of restricting business innovation by highlighting and rewarding 'standardised' positive impacts over those that are truly innovative. While standardisation of reporting on specific positive impacts can be addressed by further developing the EU Taxonomy, the role of non-financial reporting is to ensure transparency on negative impacts to people and the environment, as well as risks to companies and their management, that may be supported by targeted positive impact KPIs, where such KPIs capture how effective a company's management of underlying impacts and risks is. For example, when it comes to supply chains, this concerns attainment of certain labour conditions such as living wage and collective bargaining.

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Content point 37 of interim report: [...] As regards the principles of quality of non-financial reporting (organisation and presentation of data points), there is also a lack of precision that creates difficulties for reporting entities to prepare understandable non-financial statements and for users to access meaningful information. [...]

Comments: We fully agree with this finding. The research of the Alliance for Corporate Transparency highlights that only 22% of companies report KPIs in summarised statements; the rest either do not report KPIs (11%) at all, or scatter KPIs throughout their non-financial statements (67%).

An additional point to highlight is that according to the Alliance findings, there is a lack of connection between the use of standards and the disclosure of decision-useful data. In some cases the indicators suggested by existing standards allow companies to convey relevant information, but some companies take a flexible approach to their application, while in other cases, especially with regard to human rights topics, the problem is that such indicators do not convey decision-useful information. For example, 54% of companies of the 1000 analysed by the Alliance in 2019 and 70% of the 300 analysed in 2020 reported to rely on GRI standards, but the share of companies providing specific information on key matters was on average 20-30%.

Materiality

Content point 30 of interim report: Categorisation of topics and subtopics. Non-financial information can address a significant variety of topics, from environmental to people matters (including human rights), governance, or anti-corruption issues. Non-financial information does not have obvious borders and may evolve as new issues emerge and become more relevant over time [...].

Comments: This is true, however, climate change and human rights are clear priorities for decades to come. The standards should deal with such essential topics as a first step, including a clarification of both (a) principles for materiality determination reflecting the specifics of each topic and (b) specific reporting requirements.

Content point 31 interim report (summary): The concept of double-materiality is already reflected in the current EU NFRD, and the issue lies in how this can be applied at the level of standards and operationalised in a manner consistent with the objectives of the EU Non-Financial Reporting Directive.

Comments: We fully support the adoption of double-materiality for EU standards. The alignment of a company's materiality assessment to include impacts on people and the environment is critical in its own right (as per UN Guiding Principles on Business and Human Rights and related OECD Guidelines and Guidances), but in the long run also to ensure the future fitness of companies (please see the Future-Fit Business Benchmark). In practice, most companies do not differentiate between the two sides of double-materiality as much as they are being discussed and differentiated in the work of the standard-setters and in the policy debate. Businesses report on issues they deem relevant and for those that have immediate implications for business strategies and risks, they add further information. Investors and investor-led standards also focus on certain issues they declare as relevant from a financial perspective, despite these not being necessarily financially material - at least in the strict sense (rather for future financial developments). A good example of this is SASB's approach, which is explicitly framed as being focused on sustainability topics that matter most to investors; however, whether many of the indicators provided in SASB's standards are indicative of a company's financial performance and risks is debatable.

More importantly, for certain issues, there are objective ways to determine materiality, at least from the 'impact' perspective. This is primarily the case of human rights, as provided by the due diligence concept outlined in the UN Guiding Principles on Business and Human Rights. Another is climate change, where the defining criterion is the alignment with public decarbonisation objectives. Such an objective impact perspective is essential for the correct assessment of financial implications of such sustainability matters for the company. It serves to identify further information on risks and opportunities as well as to set related plans. The financial risk lens should be understood as an additional lens, and not one that should be used for the exclusion of severe impacts on people/planet that do not carry manifest financial risk.The interaction between the two sides of materiality differs according to the topic at hand; In climate matters, there is a strong overlap between the two perspectives which results in a greater emphasis on financial risk, in particular with respect to the alignment with public decarbonisation goals; for human rights matters such an overlap can be less clear and thus should not be a filter to exclude salient human rights issues based on the consideration of a company's connection to severe impacts on people.

Content point 33 of interim report: Scope of reporting. Many users consider that non-financial information should include information related to the whole value chain of the company, including supply chain operations (upstream) as well as products sold and services rendered down to end-of life (downstream), far beyond the boundaries applied to financial information, which covers an entity's own operations (scope of financial consolidation). [...]

Comments: This requires thematic and sector-specific clarifications, as there is no 'one size fits all' approach. For example, the relevance of reporting on Scope 3 greenhouse gas emissions depends on sector-specific considerations, as does the possibility to standardise reporting requirements relating to supply chain transparency (this differs from the scope of due diligence, whose applicability covers all sectors and the entire value chain, although -again- the application of specific qualitative and quantitative indicators for different levels of the value chain is primarily determined by the type of business activities carried out by the reporting company).

Quality of information

Content point 37 of interim report (summary): The quality of non-financial information and reporting does not meet users' diverse needs and is overall insufficient. It is important to define attributes to ensure qualitative non-financial disclosure which is aligned with that of financial information; this should also ensure the connectivity between non-financial and financial disclosure. It will also be important to clarify principles for the organisation and presentation of data points, as the current lack of precision creates difficulties for reporting entities to prepare understandable non-financial statements and for users to access meaningful information.

Comments: We agree with the assessment that the quality of corporate disclosure is poor and does not meet users' needs; as proven by the research of the Alliance for Corporate Transparency, the quality of disclosure is not sufficient to ensure access to relevant information (e.g. 36% report on climate targets, but only 13.9% highlight whether their target is aligned with the Paris Agreement). Overall, we agree with the gaps identified by the PTF and distinguish 3 solutions:

- Definition of qualitative reporting principles (e.g. for human rights: due diligence implementation, engagement of impacted stakeholders, salient issues, targets tied to the prevention/mitigation of identified issues and impacts);
- Specification of KPIs that companies do not apply uniformly, as documented by the research of the Alliance for Corporate Transparency (the greatest discrepancies were found for disclosure of climate change mitigation targets, Scope 3 emissions, and supply chain transparency data);
- Focus on the identification of relevant KPIs for issues where the current array of indicators do not facilitate disclosure of reliable and useful data. This is particularly the case for biodiversity and human rights related supply chain matters, for which generally applicable KPIs cannot provide comprehensive and comparable insights; instead the focus should be placed on determining a limited set of meaningful cross-cutting KPIs with a supportive function (including workforce composition, gender pay gap, living wage, collective bargaining)

These are high-level solutions, and will require much clearer specifications, in particular with regards to reporting on impacts and targets (forward-looking), which differ from attributes of financial information.

Content point 34 of interim report: Time horizon. While financial information, as expressed by financial statements, is essentially retrospective, it is generally considered important to put the emphasis on the forward-looking dimension of non-financial information in addition to retrospective information on performance. Time horizons that are considered adequate to address the sustainability challenges ahead may vary considerably.

Comments: This finding is supported by the research of the Alliance for Corporate Transparency. While companies disclose general and often vague policy commitments on sustainability issues, a majority of them (about half of those disclosing their policy) fail to provide specific information on the implementation of such policies, hence on the company's seriousness to manage impacts and risks, as well as plans and objectives (for example, while

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56.6% of companies report on human rights risks, only 3.6% disclose KPIs or examples documenting effective management). To overcome these shortcomings, EU standards need to specify detailed principles/criteria for (a) the quality of disclosure of forward-looking information with a focus on setting targets and disclosure against them, as well as on outcomes of policies and processes; and (b) for the quality of disclosure of information related to due diligence processes. This is applicable in general, but particularly needed for issues where it is not possible to provide standardised KPIs. Nevertheless, for climate change matters, where the performance can be tracked through KPIs, it is important to specify how companies should report on the alignment of their targets and timelines with the Paris Agreement goals and EU decarbonisation plans. As regards other matters, detailed quality criteria need to be set.

Content point 35 of interim report: Sector-agnostic, sector-specific and entity-specific approaches. [...] A standardised approach could also include elements such as governance oversight, and related policies and procedures, and strategy on topics covered by the NFRD and connections between those topics [...]

Comments: EU standards should provide thematic/topical clarifications for specific reporting requirements, as well as define the sectors for which these apply. In addition, transparency on how companies integrate the results of their materiality determination is of critical importance. Yet, only very few companies provide meaningful information on this. For example, while almost half of companies report on formal governance arrangements to support sustainability (42.9%) and on how sustainability is reflected in Board and senior management mandates (46.2%), just 1 in 7 companies (14.3%) provide at least some information on concrete sustainability matters discussed and resulting decisions made by the Board.

The European Commission plans to present a legislative proposal strengthening directors' duties in this regard. As a consequence, in addition to much needed thematic standards, there is a need for a sector-agnostic standard clarifying what information should be provided on how the outcomes of materiality determination are reflected in targets and objectives, and how these are integrated in corporate strategy as a whole. This is particularly important for issues that can only be tackled through changes to the company's business model. Such a standard should not be confused with transparency on the process of materiality determination, which should be addressed - when necessary - for individual topics, in the context of thematic standards.

Content point 38 of interim report: [...] Any reference to global policy priorities and related standards or initiatives should consider the risk of reporting entities referring to those global policy priorities (such as SDGs, that may be considered communicating a certain legitimacy or credibility) without significantly aligning their strategy with these goals (including through their materiality assessment process). The articulation between global and EU policy objectives should also be considered.

Comments: The results of the Alliance for Corporate Transparency research confirm this point. A large share of companies reporting to be aligned with global and EU standards such as the SDGs, fail to provide relevant information on their efforts to reach such goals. Rather than encouraging companies to rely on the existing voluntary standards, as the EU NFRD currently does, global and EU policy objectives should guide the development of standards, that in turn should clearly define specific targets and KPIs by means of EU standards; these would ensure the integration of EU goals in company strategies.

Content point 58 of interim report: Different reporting provisions put different emphasis on reporting of actual data compared to providing information on progress over time, on outcomes and on impact and/or on providing a forward-looking perspective. Existing provisions appear to focus rather on documentation and reporting per se instead of driving real action. [...]

Comments: We agree with this assessment. The solution is mandating companies to report on targets and outcomes and providing clear and detailed principles as well as qualitative requirements for their disclosure. See our comments on points 34 and 35 above. For material issues, reporting on targets and outcomes of policies is critical for any company that tries to address the underlying risks or impacts; if not, then this suggests that the issue might not be material after all.