CDSB's position and red lines on the Non-Financial Reporting Directive review

Note: This paper is the third update to our original drafted red lines released in 2020. The update aims to reflect on the current state of play in the discussions on the review of the Directive ahead of its publication in April 2021.

The red lines are drawn upon evidence from real world implementation of the Directive based on CDSB's reviews of annual reports published by European largest companies by market capitalisation. The latest review "The state of EU Environmental Disclosure in 2020" was published in December 2020.[1]

Why do we need a review of the NFRD?

Despite the entry into force of the Non-Financial Reporting Directive (NFRD) in 2017, reporting far too often still fails to offer investors a clear understanding of companies' development, performance, position and impact, as it lacks the necessary quality, consistency, comparability and coherence.

This **lack of material climate and other environmental information** has been illustrated in various reports including CDSB's reports of a set of top 50 European companies by market capitalisation, released in May and December 2020, the Alliance for Corporate Transparency's analyses of the sustainability reports of 1000 companies in 2019 and 300 companies in 2020 and the EFRAG European Lab Project Task Force on Climate-related Reporting report: How to Improve Climate-related Reporting - A Summary of Good Practices from Europe and Beyond.

Additionally, the NFRD needs to **reflect the current policy priorities of the European Green Deal** and **the need for investors, civil society but also policy makers and supervisors to access reliable information on environmental, social and governance issues**. Since the original proposal, expectations from a range of stakeholders as well as the urgency to act on such topics have only increased. It was also reflected by the growing number of legislations within the EU, such as the Taxonomy Regulation or the Sustainable Finance Disclosure Regulation (SFDR), a number of which are due to be implemented in the near future, based on the disclosure of information by companies under the NFRD.

Increasing the consistency and comparability of sustainability reporting is a key objective of the review. To achieve a comprehensive corporate reporting system based on existing reporting standards and frameworks, the Corporate Sustainability Reporting Directive (CSRD) plans for the adoption of European sustainability reporting standards. The ongoing international standardisation process offers an opportunity to **standardise reporting on enterprise value and set of global baseline, on which Europe can build on and innovate beyond to reflect its own policy priorities.**

To address this lack of decision-useful information for investors as a result of the current shortcomings of NFRD and ensure that its update is a success, CDSB has developed **12 red lines to guide the review and make the Directive more fit for purpose** to respond to the above-mentioned challenges.

[1] The state of EU Environmental Disclosure in 2020 | Climate Disclosure Standards Board (dev-cdsb.pantheonsite.io)

1. **Make reporting information material for enterprise value creation in the management report mandatory**

As highlighted in the public consultation on the NFRD review, the European Commission found that "It is hard for investors and other users to find non-financial information even when it is reported" and that reported non-financial information is not sufficiently reliable. Non-financial statements reported outside of the management report are also not required to be filed in the Officially Appointed Mechanisms (OAMs) designated by Member States pursuant to Article 21(2) of the Transparency Directive, further hindering accessibility of this information.

This aligns with CDSB's findings around non-financial disclosures provided outside of the mainstream report often being fragmented in nature and not readily referenced from the management report. **In 2020, 82% of companies provided their disclosure within the management report.** Increasingly, those providing disclosure within the mainstream report, are also choosing to **integrate the information within the relevant sections of the management report (61% of companies).**

Requiring reporting in the management report would facilitate accessibility as well as comparability of disclosures and foster stronger linkages across non-financial and financial disclosures. Other information, such as supporting data and information material from a broader sustainability perspective, can be of vital importance and should be reported outside the management report, in standalone sustainability reports.

2. **Increase the current scope to include large undertakings with >250 employees, as already defined in the Accounting Directive[2]**

As stated in the joint statement from June 2020 signed by CDSB, together with a group of stakeholders:

"Whether companies have a significant impact on the environment and society does not depend on their size or legal status, neither are investments limited to assets listed on stock exchanges.

We therefore recommend **reviewing the scope beyond large publicly listed entities to cover those companies that have a significant impact on the environment and society** as a result of economic activities and business models to ensure well targeted reporting. It is important though to have a balanced approach towards creating a reporting system that as an end result would ensure smart reporting, feasible for all kinds of companies."

3. **Strengthen linkages between non-financial and financial information, by ensuring an implementation of the TCFD Recommendations, including information on the financial impacts of climate on the business**

As requested by the TCFD Recommendations, supporting non-financial claims with verifiable financial data and impacts provides an additional layer of reliability to the report and a clear understanding of dependencies on non-financial matters.

In practice, however, few companies are achieving the full potential of a more integrated disclosure, by considering the requirements in tandem, with **a standalone TCFD report with similar information to the one included in their non-financial statement.** As a result, **the financial impacts of non-financial matters are currently missing from management reports.**

[2] fulfilling 2 out of the following 3 criteria: - Balance sheet total of at least EUR 20 million - Net turnover of EUR 40 million - Minimum 250 employees

The **synergies in subject matter between the revised NFRD and TCFD** represent an opportunity to facilitate more harmonised, streamlined, and consistent reporting.

4. **Fully embed the TCFD Recommendations in the Directive and for all ESG dimensions, such as biodiversity and natural capital, to drive uptake at the necessary pace and scale to support investor decision-making**

According to CDSB's findings, while **68% of companies referenced or provided some disclosure aligned to TCFD in 2020 in their reports**, the vast majority have still only partially adopted the 11 recommended disclosures.

Despite the integration of the TCFD recommendations into the Directive's 2019 Guidelines on reporting climate related information, the challenges in the quality and completeness of disclosures call for integration of the TCFD recommendations into the revised Directive itself to have a unified approach of TCFD disclosures, with the least reporting burden on companies.

ESG information in the management report should therefore cover all four elements of the TCFD (i.e. Governance, Strategy, Risk Management, Metrics & Targets). As stated by the TCFD recommendations, Risk Management and Governance of ESG matters shall be disclosed regardless of materiality.

5. **Strengthen governance disclosures by incorporating TCFD recommended disclosures on governance into the corporate governance statement in Article 20 and in sustainability information in articles 19a and 29a of the Accounting Directive**

Board oversight of environmental and climate change matters is not a disclosure obligation under the current NFRD, although the Directive does provide that companies include information on their diversity policy within a corporate governance statement in their management report under Article 20. The requirements to include such information should be extended beyond diversity policy to cover other ESG issues.

CDSB's review found that governance disclosures, although improving, often **lack clarity on board oversight and the management's role** in assessing and managing environmental matters. They also demonstrate **confusion among preparers with other content categories (e.g due diligence)** and **duplication of information between the corporate governance statement and the non-financial statement.**

6. **Ensure that enterprise value materiality is reported under the double materiality concept**

The definition of double materiality included in the Directive should reflect **the diversity of users of the non-financial information** and their related needs as well as **the dynamic nature of materiality**.

There are two nested materiality concepts used by companies for sustainability disclosure**:**

- A company determines the sustainability topics that are material for disclosure based on the organisation's significant impacts on the economy, environment and people, and their importance to its stakeholders. This corresponds to the "Environmental and Social" element of double materiality; and
- Enterprise value: A *subset* of such sustainability topics for users who primary objective is economic decision-making (such as many institutional investors) that are material for enterprise value creation. This corresponds to the "Financial" element of double materiality, although it *goes beyond financial figures*.

It is important to reflect on the dynamic nature of materiality over time, meaning that **sustainability topics that a company once considered immaterial for disclosure can become material,** based on evidence of an organisation's impacts on the economy, environment and/or people. Likewise, **some of these sustainability topics can also become material for enterprise value creation**.[3]

7. Review the principal risk requirement of the Directive to ensure emphasis is placed on risk and impacts on the business, as well as by the business

Principal risk disclosures relating to environmental matters were generally found to be the weakest of the five core content categories of the Directive in CDSB's 2020 review of corporate reports. While 86% of companies did disclose at least one principal risk relating to climate or environment, **only 32% disclosed business model impacts and 29% did not disclose any impacts on their financials, operations, or business models.** Additionally, **only 4% of companies defined the short, medium and long-term time horizons over which the identified risks would impact the organisation.**

It is therefore clear that the Directive's existing risk disclosure requirements are not delivering the information investors require on the financial, operational and strategic risks companies face and should be reviewed accordingly, based on the TCFD Recommendations. The new reporting requirements should include **information on the identification, the assessment and the management of climate and environmental risks.**

Information on risk and impacts on the business that can impact value creation should be reported within the management report of companies whereas information on risk and impacts by the business would need to be reported in a separate sustainability report.

8. Specify that "environmental matters" cover all elements of natural capital including climate, water, biodiversity, deforestation and forest degradation to ensure a full coverage of environmental issues

While the Directive's Guidelines refer to the United Nations Sustainable Development Goals, the Paris Agreement and the TCFD Recommendations, neither climate change nor biodiversity are explicitly referred to in the NFRD's wording under "environmental matters". The lack of specify within the NFRD's wording has created confusion for preparers and inconsistences in reporting practice when comparing disclosures, resulting in a lack of disclosures on climate-related information.

CDSB's review found a clear disparity in the level and quality of disclosure on different environmental aspects. Whilst all companies referenced climate change in their reporting and **94% mentioned water-related issues, only 46% made reference to biodiversity and 22% for deforestation and forest degradation.**

It is therefore necessary to :

- **Incorporate 'climate' into the wording of the Directive** to ensure companies consider climate-related matters explicitly in their disclosures, including the associated financial impacts; and
- **Ensure that environmental issues beyond climate, including biodiversity, water and forests, are clearly integrated and addressed,** to support wider EU policies.

[3] For further information on the concept of dynamic materiality, refer to the Statement of intent to work together towards comprehensive corporate reporting, published by CDP, CDSB, GRI, IIRC and SASB in September 2020. Statement of intent to work together towards comprehensive corporate reporting | Impact Management Project

9. Provide definitions for key terms used in the Directive, such as “policies”, ‘due diligence’ and “outcomes” to ensure a common understanding and application of the Directive content categories

Although companies are disclosing their environmental and climate-related policies, as well as their due diligence processes, there is significant variation, because these terms are not defined within the Directive.

CDSB’s review found that **policies often lacked business-specific detail** and that **30% of due diligence disclosures failed to include board and management-level accountabilities.** Reporting on outcomes was also not clearly linked to stated policies and few reports were able to provide balanced disclosure that fully addressed areas of weakness in policy progress.

The significant variation in interpretation of these content categories shows that **key terms should be defined within the Directive to ensure common understanding and application** of these requirements. Having high quality disclosures of policies is particularly critical to provide the basis for a coherent and connected disclosure on other content categories.

10. Ensure that supervision of non-financial information by National Competent Authorities is at the same level as for financial information, in order to provide authoritative feedback to corporate report preparers

Supervision by NCAs should be strengthened further and is already overseen by ESMA whose last enforcement report stated that during 2020, European enforcers undertook 729 examinations of non-financial statements. Such examinations led to 42 enforcement actions, causing an action rate of 5% (10% in 2019). The overwhelming majority of actions were requiring the issuer to make a correction in a future non-financial statement on one or several areas.

Separate reports that include non-financial information hinder appropriate supervision because they are out of the legal mandate of the National Competent Authorities (NCAs), who can only supervise and enforce non-financial information if it is set out within the management report or published together with it. Some NCAs currently only have the power to check the existence of the non-financial information as opposed to the content or do not have any supervisory powers on non-financial information at all.

Non-financial information should be subject to the same level of supervision as financial information to enable corporate report preparers to receive feedback that facilitates high quality disclosure, be it financial figures or sustainability information. It is also important to underline that further clarification of the Directive’s requirements themselves will help strengthen and improve further supervision and enforcement activities.

11. Ensure in the revision of the Directive that the different content elements provide a connected overall view on how companies ensure sustainable long-term value creation

While disclosure of information under individual content categories of the Directive have improved overtime, coherence and connectedness across environmental disclosures within a report is critical to ensure it is decision-useful for investors. CDSB’s 2020 review found that information across content categories was not always well linked, with **14% disclosed policy outcomes not clearly relating to their stated policies,** and **36% of disclosures reviewed not indicating any explicit management actions being taken to address their principal risks.**

In order to drive disclosure that provides a complete and consistent picture on the organisation’s overall approach to sustainable long-term value creation, it is therefore key that the revision of the Directive places greater emphasis on **ensuring companies’ disclosure across content categories tells a clear overall story** regarding its approach to environment, social and governance issues and how they are incorporated into business decision-making.

12. **Incentivise companies to do more to tackle environmental and climate issues, through ambitious policies and rigorous due diligence processes, and, by ensuring policy coherence between the NFRD review and the upcoming EU initiative on corporate governance**

While due diligence disclosures under the NFRD are expected to provide information on board and management level responsibilities of relevance from a corporate governance perspective, CDSB's findings show that **30% of companies did not provide this information relating to environmental matters in their 2020 reports.** Additionally, where governance information was provided, the level of detail and specificity included on how environmental risks, and in particular climate risk, were managed, was often limited.

The revision of the NFRD therefore presents a timely opportunity to **ensure that companies disclose information on their internal due diligence processes and responsibilities over environmental issues**, while the EU also takes legislative action to boost responsible business conduct through the upcoming initiative on sustainable corporate governance. Both reforms should be carefully designed in their scope and requirements to ensure consistency and complementary of the two. Reporting requirements will ensure that the Board and the Management have the relevant information at hand to design and implement the relevant sustainability strategy while corporate governance reforms will aim to ensure the relevant processes, reflected in the quality of the sustainability reporting, are in place.

About CDSB

The Climate Disclosure Standards Board (CDSB) is an international consortium of business and environmental NGOs. We are committed to advancing and aligning the global mainstream corporate reporting model to equate natural and social capital with financial capital.

We do this by offering companies a Framework for reporting environment- and social-related information with the same rigour as financial information. In turn this helps them to provide investors with decision useful environmental information via the mainstream corporate report, enhancing the efficient allocation of capital. Regulators have also benefited from CDSB's compliance-ready materials.

Recognising that information about natural, social and financial capital is equally essential for an understanding of corporate performance, our work builds trust and transparency needed to foster resilient capital markets. Collectively, we aim to contribute to more sustainable economic, social and environmental systems.

For further information and feedback

CDSB always welcomes feedback from all stakeholders on the position and red lines above. Please contact Axelle Blanchard, Policy Manager (axelle.blanchard@cdsb.net).