FULL DISCLOSURE: MONTHLY BRIEFING ON EU CORPORATE TRANSPARENCY REGULATION · MARCH 2021 ISSUE

Reform of the EU Non-financial Reporting Directive: A Push Towards Future-proof Reporting Obligations

"We need to mobilise at least half a trillion euros per year of additional investments in the EU", EU Commissioner for Financial Services Mairead McGuinness has been crystal-clear in her public appearances. She has identified the **reform of the EU Non-Financial Reporting Directive (NFRD)[1] as "one of the priorities to strengthen the foundations for sustainable investment"**. Without reliable, comparable and meaningful sustainability data from companies, investors and banks will not be able to incorporate long-term sustainability risks into their decision-making as well as to redirect needed finances towards sustainable and future-proof investments. This will leave companies blind to major business risks and opportunities in the rapidly evolving economy.

In 2018, the EU Non-Financial Reporting Directive NFRD introduced obligations for large European companies to disclose information on their sustainability risks and impacts. However, as shown by the Alliance for Corporate Transparency[2] research, the quality and relevance of information is still critically poor[3]. The EU NFRD therefore is missing its point of legislation. The latest data for instance reveal that only 13.9 percent of companies explain alignment of their policies with science-based targets and only 6.6 percent use a below 2°C scenario in their risk assessment. In Germany, the numbers are 14.8 % for a science-based Paris-aligned target and 7.4% for the usage of a below 2°C scenario.[4]

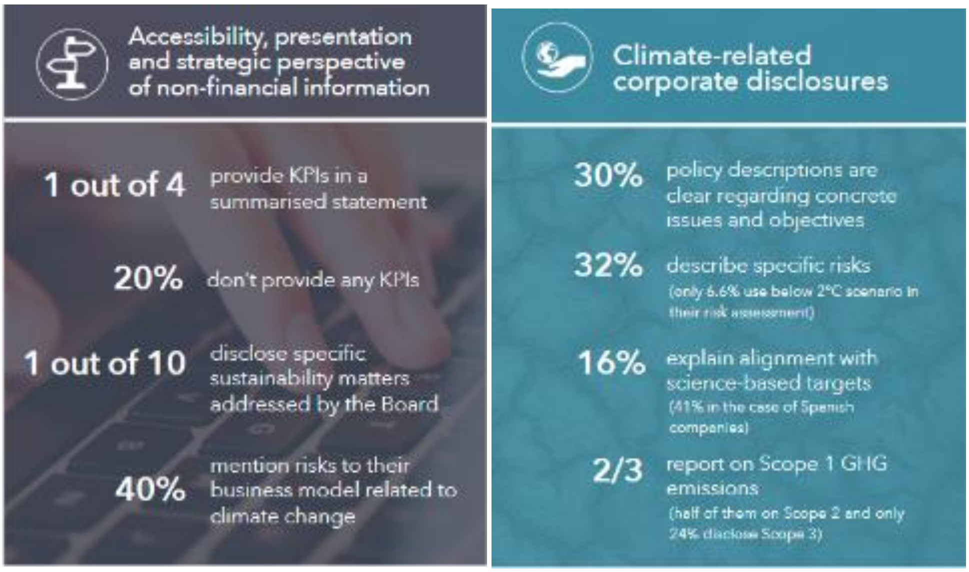
Why is the reform needed?

Similar to financial accounting, **sustainability data** is becoming **essential for effective corporate management of pitfalls and opportunities in a fast-changing world**. Customers, investors and banks also start to require such data to evaluate companies' strategy and long-term viability, and factor them in their business decisions. In particular, they **require forward-looking information**. Governments and companies alike need to deliver on the commitments they have made in the context of the Paris Agreement and Sustainable Development Goals. However, various studies show that existing reporting is not

[1] European Commission: Non-financial reporting: EU rules require large companies to publish regular reports on the social and environmental impact of their activities. https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en. Last retrieved: 2021-03-15.
[2] Alliance for Corporate Transparency (2021): http://www.allianceforcorporatetransparency.org/.
[3] Alliance for Corporate Transparency (2020): Landmark research on 1000 European companies shows troubling poor quality of reporting on sustainability issues. http://allianceforcorporatetransparency.org/news/landmark-research.html. Last retrieved: 2021-03-15.
[4] Alliance for Corporate Transparency (2019): EU Database 2019: Database Archive: Companies individual assessment. https://www.allianceforcorporatetransparency.org/database/2019.html. Last retrieved: 2021-03-15.

compatible with these goals and that a lack of integration of forward-looking data with financial reports means the information is not sufficiently useful for business decision-making either.[5]

Figure 1: The assessment of the Alliance for Corporate Transparency of climate-related data disclosed by 300 European companies shows that most companies don't work with and disclose relevant data and information.[6]



What changes will the NFRD reform bring and which topics can we expect to be the main discussion points this year in the EU?

With the reviewed NFRD, the EU Commission will follow up on the Action Plan on financing sustainable growth[7] with the NFRD reform proposal alongside with a renewed sustainable finance strategy until end of Q2/2021. In advance to the revision, 82 percent of business, investors and civil society organisations called for mandatory reporting obligations and the clarification of the legal framework.[8]

10 expected key points of the reform proposal

Below, we outline ten key issues that the Commission is likely to address in the reform. Most critically, the reform will extend the scope of the law.

<u>Expansion of the scope:</u>

1. Currently, the Directive applies to approximately 5,000 thousand companies, which may be extended to an additional range of at least 35,000 large companies, up to 100,000 businesses if

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[5] Umweltbundesamt (2021): Management von Klimarisiken in Unternehmen: Politische Entwicklungen, Konzepte und Berichtspraxis. https://www.umweltbundesamt.de/sites/default/files/medien/5750/publikationen/2021_02_01_cc_052021_management_klimarisiken_0.pdf. Last retrieved: 2021-03-15.

[6] Alliance for Corporate Transparency (2020): New data shows some, yet insufficient progress in companies' climate and environmental disclosures at a turning point for sustainability reporting in Europe. https://www.allianceforcorporatetransparency.org/assets/Key_findings.pdf. Last retrieved: 2021-03-15.

[7] European Commission (2018): Renewed Sustainable Finance Strategy and implementation of the action plan on financing sustainable growth. https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en. Last retrieved: 2021-03-15.

[8] European Commission: Non-financial reporting by large companies (updated rules). https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-/public-consultation. Last retrieved: 2021-03-15.

high-risk medium-sized companies are included in EU-27. Very likely, the NFRD scope will be extended **to include all large companies** (both those with assets listed on stock exchanges and private) with more than 250 employees (for illustration, that would apply to approx. 12,000 companies in Germany and 0.2 percent of all EU enterprises)[9];

2. In addition, there is an ongoing **debate on small or medium enterprises that have a high impact or face high risks**, such as energy producers or importers of high-risk commodities, to be included in the scope of the new obligations with reporting requirements being proportionate to their size and impact and thus avoiding a "one size fits all" approach. With an estimated proportion of 20 - 30 percent of companies in high-risk sectors, this means an additional 41,000 - 62,000 medium-sized companies in EU-27 will also start falling under the NFRD scope (0.2-0.3 percent of all EU enterprises)[10]. Depending on the final extension of the scope, 12,000 - 30,500 companies in Germany might fall under the reformed NFRD.[11]

<u>Mandatory reporting standards:</u>

3. New qualitative criteria for **disclosure of forward-looking information** on identification of risks and setting the targets.
4. Definition of information needed to understand **companies' climate transition plans**, including timeline, intermediary objectives and time horizons, and alignment with the public objectives and science-based targets.
5. **Disclosure requirements concerning human rights and environmental due diligence** regarding management of risks and impacts in supply chains. The EU NFRD already requires this type of disclosures. However, only 1 out 5 companies fulfils these requirements according to independent findings by the Alliance for Corporate Transparency, Corporate Human Rights Benchmark of the World Benchmarking Alliance, and the German government.[12]
6. Mandatory, but **sector-sensitive Key Performance Indicators** (KPIs) in the area of climate change (e.g. greenhouse gas emissions Scope 1, 2 and 3), use of natural resources and biodiversity impacts and pollution, and workforce statistics (composition, wages, collective rights).

<u>Other specific topics likely to be included in the reform:</u>

7. **Integration** of sustainability reporting **within annual reports**.
8. **Governance and integration** of sustainability **in the corporate strategy**.
9. **Clarification of the double materiality principle** (which refers to both the financial impacts stemming from sustainability topics and corporate impacts on people and the planet).
10. The **specification of mandatory assurance**.

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[9] Eurostat (2021): Number of enterprises in the non-financial businness economy by size class of employment. https://ec.europa.eu/eurostat/databrowser/view/tin00145/default/table?lang=en. Last retrieved: 2021-03-15.
[10] WWF (2020): Expanding the scope of the EU corporate sustainability reporting: WWF recommendations.
[11] WWF (2020), Eurostat (data for 2017): Estimation based on calculations by the Alliance for Corporate Transparency based on WWF and Eurostat.
[12] Auswärtiges Amt (2020): Monitoring des Umsetzungsstandes der im Nationalen Aktionsplan Wirtschaft und Menschenrechte 2016–2020 beschriebenen menschenrechtlichen Sorgfaltspflicht von Unternehmen: Abschlussbericht. https://www.auswaertigesamt.de/blob/2417212/9c8158fe4c737426fa4d7217436accc7/201013-nap-monitoring-abschlussbericht-data.pdf. Last retrieved: 2021-03-15. , CHRB (2020):2020 results. https://www.corporatebenchmark.org/2020-results. Last retrieved: 2021-03-15.

Advantages of standardisation

Companies struggle to meet the multiple and sometimes confusing external expectations they face and that they themselves want to support (climate change targets, SDGs, sustainable investment), but need help in order to translate them in practical terms. The EU NFRD framework can provide clarity to pull these different expectations together and provide more certainty for those in business to apply them. Equally, however, in case it fails to set clear minimum standards, it may just reinforce the competition between private reporting initiatives and rating agencies promoting their own standards.

Therein, standardisation of reporting simplifies automatic data collection and reduces costs. It allows banks to include climate risk assessments into their target-setting and supports the integration of sustainability data into corporate strategy by the board. The legislation is an opportunity to simplify the reporting landscape and assist companies in focusing on the right data.

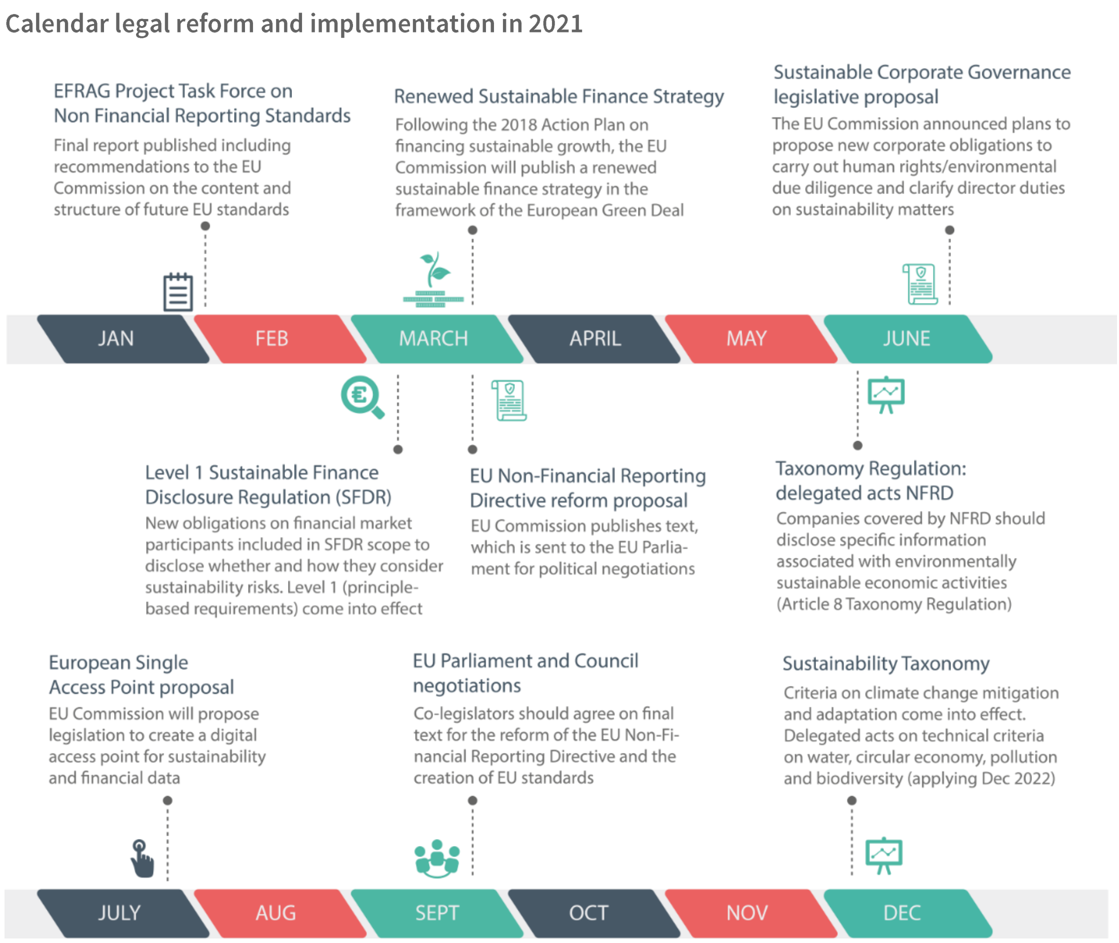
Don't miss the train

According to Silke Stremlau, member of the managing board at Hannoversche Kassen, it is certain that **investment decision-making will change** "due to greater transparency than today, with investors that can clearly see the differences between companies, their climate impact and future ambitions."[13]

The clarification of corporate **sustainability reporting obligations can address major challenges** facing companies and investors alike. It can **overcome the current confusing reporting landscape**, set **focus on data that really matters**, and **expand the availability of finance** for those companies who are leading the way. In the words of Commissioner McGuiness, the reform of the EU NFRD is meant to be a targeted intervention to ensure that "we channel investments into companies that can deliver on our green and sustainable objectives".

When the NFRD was introduced in 2018, it showed that it was possible for companies to undertake **non-financial reporting without undue cost or burden**. However, there is recognition that it is still too focused on compliance by producing a report, rather than on generating information, which is useful to internal as well as external stakeholders in managing the sustainability performance of the company for the benefit of all.

[13] Serenelli, Luigi (2021): German investors expect positive impact of new EU disclosure rules. https://www.ipe.com/news/german-investors-expect-positive-impact-of-new-eu-disclosure-rules/10050752.article. Last retrieved: 2021-03-15.



Author(s): Filip Gregor, Head of Responsible Companies Section at Frank Bold
Editing: Milena Ostrower, Policy Advisor Sustainable Finance at Germanwatch

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Germanwatch e.V.
Office Bonn
Kaiserstr. 201
D-53113 Bonn
Phone +49 (0)228 / 60 492-0, Fax -19
Website: www.germanwatch.org

Office Berlin
Stresemannstr. 72
D-10963 Berlin
Phone +49 (0)30 / 2888 356-0, Fax -1
E-mail: info@germanwatch.org

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