ICGN
International Corporate Governance Network

European Commission
Directorate General for Financial Stability,
Financial Services and Capital Markets Union
1049 Bruxelles
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Submitted via online questionnaire

11 June 2020

Subject: ICGN Response to the European Commission consultation on the review of the Non-Financial Reporting Directive

The International Corporate Governance Network (ICGN) is pleased to respond to the European Commission (EC) consultation on the review of the Non-Financial Reporting Directive (NFRD).

Led by investors responsible for assets under management in excess of US$54 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our membership is based in more than 45 countries and includes companies, advisors and other stakeholders. ICGN's mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation contributing to sustainable economies world-wide. Our policy positions are guided by the ICGN Global Governance Principles[1] and the ICGN Global Stewardship Principles,[2] both of which have been developed in consultation with ICGN Members and as part of a wider peer review. For more information on ICGN please see: www.icgn.org.

ICGN commends the EC for its global leadership in promoting sustainable finance and non-financial reporting as a means for both companies and investors to better understand the full range of sustainability-related risks and opportunities that confront them. As an investor body with a global purview, it is our hope that the EC's efforts in promoting non-financial reporting can contribute to the development of internationally accepted standards, not only in Europe, but in other markets outside the European Union.

One of ICGN's core policy priorities is to seek transparency through better reporting, audit and metrics.[3] Non-financial reporting, including reporting on environmental, social and governance (ESG) factors has become a major focus for ICGN members, particularly for investors seeking to integrate ESG factors into the investment and stewardship process. In 2018, ICGN joined forces with the Principles for Responsible Investment (PRI) and several other investor groups to publish a discussion paper on

[1] See: ICGN Global Governance Principles: http://icgn.flpbks.com/icgn_global_governance_principles_jpn/
[2] See: ICGN Global Stewardship Principles: https://www.icgn.org/sites/default/files/ICGN_Global_Stewardship_Principles_JPN_1.pdf
[3] See ICGN Policy Priorities: https://www.icgn.org/sites/default/files/ICGN%20Policy%20Priorities%202018-9.pdf

the investor agenda for ESG reporting.[4] This 2018 paper's main conclusions provide a relevant background for the EC's current consultation on non-financial reporting:

- There is a clear business case for ESG reporting for investors and companies (management and boards). Reporting can help investors and companies better understand material ESG related risks and opportunities.
- There is no single solution – one set of metrics or a single framework – that will satisfy all users of ESG data. The heterogeneity of ESG data users – investors, stakeholders and companies - will remain. However, it should be possible to serve different needs and still come to a more unified agenda. From companies' perspective, ESG issues are endogenous and difficult to standardise. In spite of these challenges, we believe that companies should seek to identify and publish material ESG issues and relevant Key Performance Indicators (KPIs) as part of their annual reports. Integrated reporting may provide a good framework for this.
- At the same time, it would be beneficial for companies to disclose standardised ESG information at a basic level to complement more customised ESG reporting, just as financial accounting has required its own disclosure standards.
- Both investors and companies need to think more about systemic issues, including the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, the UN Sustainable Development Goals (SDGs) and their links to individual companies. For companies, this is a matter of strategy and sustainable value creation. For investors, particularly those with longer term time horizons, systemic risks need to be reflected in valuation models and incorporated into engagement with company executives and board members.
- Investors would benefit from members of the Corporate Reporting Dialogue[5] proactively articulating how the individual members fit together. Where are the complementarities? Where are the disconnects or conflicts?

ICGN's consultation response to the EC NFRD consultation builds from this context. We address in turn the individual consultation themes, which will accompany our response to the questionnaire.

1. Quality and scope of non-financial information to be disclosed

Non-financial reporting continues to develop positively and is increasingly common. But it has not come close to reaching its potential. We agree with EC's assessment that there is significant room for improvement in NFRD disclosures. We cite the 2019 study by the Alliance for Corporate Transparency (ACT) of 1000 EU companies.[6] The ACT report highlights many of the current weaknesses in current non-financial

[4] George Dallas, ICGN and Kris Douma, PRI: Investor Agenda for Corporate ESG Reporting, October 2018: https://www.icgn.org/sites/default/files/ESG%20Reporting%20Discussion%20Paper%20FINAL.pdf

[5] The Corporate reporting Dialogue is a set of 8 providers of standards for corporate reporting. Members are: The carbon disclosure Project, Climate Disclosure Standards Board, Financial Accounting Standards Board, the Global reporting Initiative, The International Organization for Standardization, International Financial Reporting Standards, International Integrated Reporting Council, and the Sustainability Accounting standards Board.

[6] Alliance for Corporate Transparency, 2019: https://www.allianceforcorporatetransparency.org

reporting practice, including limited use of KPIs, inconsistent reporting on differing sustainability risks, limited use of targets and vague disclosures on policies, practices and outcomes. More generally the report suggests that in many cases form is prevailing over substance.

A key issue is lack of comparability, which can make it very difficult for investors to make practical use of non-financial reporting to benchmark company performance. If non-financial reporting is not comparable it will inhibit meaningful research by investment analysts and academics to better understand the relationship between non-financial information and company performance.

The four main categories of non-financial information make sense: environment, social/employee, human rights and bribery/corruption. But these are broad categories and can accommodate a range of factors. For example, tax policy may be an important component of the bribery/corruption category. If there is an additional category to include, we would suggest consideration of calling for more standardised disclosures on a company's capital allocation strategy—how it manages its balance sheet, provides dividends and approaches capital transactions, as well as its cost of debt and equity capital. These are financial in nature, but different from the financial statements themselves.

2. Standardisation

We support the idea of a requirement for companies to apply a common standard for non-financial reporting to ensure for quality, consistency and comparability. ICGN recognises many capable providers of non-financial reporting standards and frameworks, and it is important to recognise that each provider has its own focus, market and audience. As an investor body, ICGN recognises that non-financial reporting standards are still in a relatively early stage of development, and it may be premature at this point to select probable winners or losers.

In terms of reporting frameworks, standardisation is important. ICGN is supportive of integrated reporting and "integrated thinking" in a broad sense as well as the specific framework that has been developed by the International Integrated Reporting Council (IIRC). At the same time, we also see traction building globally around the Task Force on Climate-related Financial Disclosures (TCFD) as a reporting framework not only for climate risks but also for other sustainability issues.

The consultation document has also identified a number of other important and well-established initiatives that compete for attention – and which also have the potential to muddy the waters in the quest of agreeing on common standards. While it is beyond the scope of this consultation it is our hope that there may be scope for further consolidation of existing initiatives or finding ways for these individual bodies to fit together more coherently.

We agree that intangible assets are an important issue related to this dialogue. It would be useful for companies where intangible assets account for an important component of their market value to provide their own view of the key drivers behind these intangible assets.

With regard to standards for small and medium sized enterprises (SMEs) there may be scope for more simplified standards and reporting formats for SMEs that are proportionate with the size of the business.

3. Materiality

The potential scope of non-financial reporting is very broad, so materiality is a critical principle to provide focus for both providers and users of non-financial information. As an investor-led body, ICGN focuses on company financial performance and returns on capital. This shapes our view towards materiality. Accordingly, we think the materiality definition of Article 2(16) of the Accounting Directive is relevant for investor needs with regard to the impact of ESG or other non-financial information on companies. But we recognise that a broader stakeholder base may wish to approach materiality in ways that are more qualitative and possibly less relevant to the financial focus of investors. Moreover, the principle of double-materiality is important in terms of informing the impact of the company on society and the environment. In this context, we believe there may be scope for clearer guidance on how the principle of double-materiality meshes with Article 2(16). For example, the literature on human rights[7] raises the concept of "salience" as an alternative to financial materiality. In this context salience might be a helpful way to frame the impact of the company on society.

An additional point on materiality is that some disclosures report on events that have happened and some focus on potential future occurrences. The forward-looking statements are important in assessing a company's value proposition, but the materiality assessment is quite different. The consultation does not include a detailed conversation on how materiality will operate with different time lines.

We agree that companies reporting under the NFRD should be required to disclose their materiality assessment process. Such assessment should focus both on the needs of investors and other stakeholders.

4. Assurance

If investors have reason to doubt the quality or credibility of a company's non-financial reporting, then this form of reporting risks not being taken as seriously as audited financial information. We would encourage the EC to develop stronger assurance requirements and would encourage the "reasonable assurance" standard over the less rigorous "limited assurance" standard for such information. In other cases, companies should disclose information that they have reported as parts of other reports, including governmental reports, and there may be less need to re-evaluate the quality of such reporting. It is also important to ensure that assurance providers are in fact qualified to provide such assurances—and that non-financial reporting standards themselves lend themselves to independent third-party assurance. This may give rise to scrutiny of non-financial individual reporting

[7] UN Guiding Principles Reporting Framework, 2015.

standards in terms of assurability, which is something the EC should consider in developing its own non-financial reporting standard.

5. Digitalisation

We also believe the EC should aspire to high standards with regard to digitisation. Enhancing user access and machine readability to non-financial information will greatly benefit users and will lead to more cost efficient and sophisticated applications of this information. In this context tagging might be regarded as an investment in a powerful information infrastructure.

6. Structure and location of non-financial information

As an investor body ICGN encourages integrated reporting of financial and non-financial information in an annual management report. This is important to understand how the narrative of non-financial performance links to a company's overall strategy, governance and financial outcomes. So we support the proposal to require companies to disclose all material non-financial information in the company's annual report.

However, we also recognise that the company may have important stakeholder groups whose interests in non-financial reporting issues may extend beyond purely financially material issues. In such cases the company may wish to provide extended reporting as part of its stakeholder relations.

7. Personal Scope (which companies should disclose)

We believe in principle that non-financial reporting should be relevant for any company, however as noted earlier there could be scope for simplification of standards for SMEs. As investors, we believe the requirement should include all listed companies in the EU. But listing need not be the limiting criteria, as there may be unlisted private companies that issue debt to institutional investors or private companies that are on a trajectory to a public listing. Moreover, stakeholders of private companies will also seek non-financial reporting, regardless of whether or not the company is listed.

We hope these comments are useful in your deliberations. If you would like to follow up with us with questions or comments, please contact our Policy Director George Dallas: george.dallas@icgn.org .

Yours sincerely,

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