Fitness check on public reporting by companies

CDSB Consultation Response – 8 March 2018

The Climate Disclosure Standards Board (CDSB) would like to thank the European Commission for the opportunity to offer our written response to the Fitness check on public reporting by companies.

CDSB is an international consortium of nine business and environmental NGOs. We are committed to advancing and aligning the global mainstream corporate reporting model to equate natural capital with financial capital. We do this by offering companies a framework for reporting environmental and climate information (the **CDSB Framework**) with the same rigour as financial information. In turn, this helps companies to provide investors with decision-useful environmental and climate information via the mainstream corporate report, enhancing the efficient allocation of capital. Regulators also benefit from compliance-ready materials. Recognising that information about natural capital and financial capital is equally essential for an understanding of corporate performance, our work builds the trust and transparency needed to foster resilient capital markets. Collectively, we aim to contribute to more sustainable economic, social and environmental systems.

CDSB has been involved in the various sustainable finance agendas of the Commission since their inception and the CDSB Framework is referenced in the non-binding guidelines on non-financial reporting.

We commend the Commission for conducting an over-arching review of the corporate reporting framework in Europe. Given recent developments in Europe, such as the Directive on the disclosure of Non-Financial Information (NFI), the recommendations of the High-Level Expert Group on Sustainable Finance, as well as international developments, such as the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), the time is right for a strategic review of Europe's approach to corporate reporting.

We would also like to bring the Commission's attention to our upcoming review of European companies' implementation of the NFI Directive.

Please find our comments below and do not hesitate to contact us if we can be of further assistance.

Kind regards,

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Responses to the Specific Consultation Questions

1. Whether the current financial reporting framework meets its objectives and will continue to do so in the digital economy, whether the level of harmonisation and simplification meets the needs of respectively the large cross border groups and the SMEs, the role of IFRS for non-listed and listed companies including governance aspects to ensure these are not detrimental to long term and sustainable investments, and the coherence of sectoral accounting legislation for banks and insurance companies with other EU reporting and prudential legislations;

Non-financial information can have financial implications

Given the heightened interest of investors in the potential financial impacts of so-called non-financial matters on the financial performance of companies, the current financial reporting framework must evolve to meet the current and future needs of the market.

The recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) have clearly outlined that climate change-related matters can have an impact on the financial performance of companies and in aggregate on the stability of the economy at large, as shown in Figure 1 below.

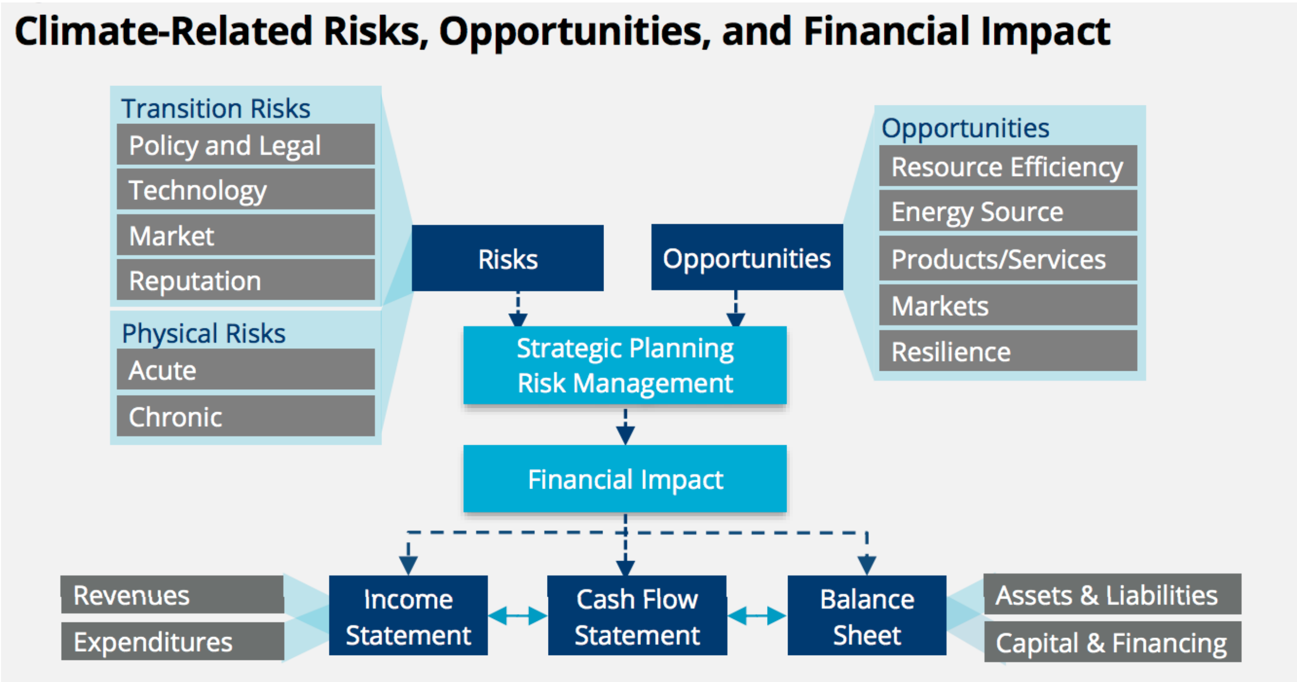

Figure 1 Source: Final Recommendations of the Task Force on Climate-related Financial Disclosures

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The role of IFRS

Given that such information has financial implications, IFRSs have a role to play in ensuring standardised, robust reporting. We have outlined how some of IFRSs may be applied for reporting in line with the TCFD recommendations in a report titled "Unchartered waters"[1], which will be published on 12th March 2018.

Some aspects of financial accounting standards require a focus on information about known liabilities associated with events that have already occurred or that create a present obligation. However, there are some new and updated financial accounting standards that set out requirements on how to deal with future risks, particularly for the purposes of measurement in accounting, and associated disclosures. The purpose of this paper is to open a discussion on whether any of the principles or practices in those standards and other materials are relevant and transferrable to climate-related risk disclosures.

There are several financial accounting standards explored in this paper which may offer insights for helping companies to respond to the TCFD recommendations and recommended disclosures, as outlined below:

- IFRS 7 "Financial Instruments: Disclosures";
- IFRS 9 "Financial Instruments";
- IFRS 15 "Revenue from Contracts with Customers";
- IFRS 17 "Insurance Contracts";
- IAS 36 "Impairment of Assets"; and
- IAS 37 "Provisions, contingent liabilities and contingent assets".

European Financial Reporting Advisory Group (EFRAG)

As referenced in the Commission's Action Plan for a greener and cleaner economy, we believe that EFRAG has a key role to play in the solution to this issue. As the organisation tasked with developing and promoting European views in the field of financial reporting and ensuring these views are properly considered in the IASB standard-setting process and in related international debates, is ideally placed to explore the relationship between IFRSs and climate change, as well as wider natural capital reporting. To do this, EFRAG must be given the authority to provide such commentary in its endorsement advices.

In addition, we support the Commission's plan to set up a European Corporate Reporting Lab within EFRAG to further explore the connections between non-financial information and IFRS.

2. Whether the financial and non-financial disclosures in the area of Environmental, Social and Governance (ESG) reporting by companies are fit for purpose, including as regards sustainability disclosures;

Given our extensive review of non-financial disclosures in ESG reporting by companies in Europe and internationally, we believe that Europe has a strong basis on which to build, but current practices and regulatory requirements do not result in information that is fit for investor decision-making in the majority of cases.

We will be undertaking a review of European companies' implementation of the NFI Directive this year, by reviewing the environmental, and in particular climate change-related, information in the management reports of approximately 10 companies from each EU Member State. Our aim is to complete this analysis by Q3 2018, which we will present to the Commission upon completion.

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[1] Climate Disclosure Standards Board (2018). Unchartered waters – How can companies use financial accounting standards to deliver on the Task force on Climate-related Financial Disclosures' recommendations? [PDF]. Available from https://www.cdsb.net/uncharted-waters.

Consistency of information

Non-Financial Reporting across the EU Member States is most likely to be inconsistent, making it difficult for key audiences such as investors to perform comparative analyses. This is due to the lack of specificity of the requirements of the NFI Directive. It is imperative to ensure more consistency in corporate reporting to achieve Europe's goals for a more sustainable market, because the flow of decision-useful information is the bedrock of finance.

This is due to the lack of specificity of the NFI Directive, as well as the lack of clarity on the standards that should guide companies in implementing the Directive's requirements. While the non-binding guidelines on non-financial reporting do offer additional guidance, they are non-exhaustive and non-binding. We believe that it is in the interest of both companies and their investors to evolve the Directive on Non-Financial Information to include more specific details, in particular around climate change and the recommendations of the Task Force on Climate-related Financial Disclosures.

In Europe, France, Sweden and the UK have already endorsed the TCFD recommendations and Germany is undertaking a feasibility study of implementing Article 173 of the French Energy Transition Law, which is widely considered to be a legislative implementation of the recommendations. It must be noted however, that Article 173 has been laid into law before the TCFD recommendations have been published and may not in practice result in the full implementation of the recommendations.

Inclusion of information in management report

Only France require the non-financial information statement to be included in companies' annual (management) reports. All others allow for separate reports to be published up to 6 months after the management report.[2] This means that investors may receive non-financial information that is:

- Not linked to the information in the management report, thus lacking the context they need;
- Not reported for the same period as the information in the management report, thus making meaningful interpretation impossible; and
- Not available to them at the time that they undertake analysis of corporate information, thus excluding non-financial information from their decision-making.

Key Performance Indicators

Italy and France have specified what information should be reported in relation to the various ESG factors, whereas most other Member States have implemented a word-for-word transposition of the basic general requirements of the NFI Directive. There is a risk, as a result, that a multitude of KPIs are used across companies in different countries, complicating comparative analysis.[1]

While more specificity in KPIs would make comparative analysis significantly easier, it is important to strike a balance between specificity and flexibility. Given that each business is unique and comprises of a multitude of business activities with varying ESG risks and opportunities, it is important to ensure that companies have the ability to report a true and complete picture of their business. As such, it is important to take into considerations specific to each sector or industry.

It is also important to note that, given the purpose of the management report, a materiality threshold must be applied to the KPIs and all other information reported. While there is a materiality condition in the NFI Directive ("…to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity…"), this definition is not in line with the International Accounting Standards Board's (IASB) definition of materiality, which must be applied for all other aspects of the report. We therefore urge the Commission to review this materiality condition to bring it in line with the IASB definition. We would

[2] https://www.csreurope.org/sites/default/files/uploads/CSR%20Europe_GRI%20NFR%20publication_0.pdf

like to bring the Commission's attention to our position paper*: Materiality and climate-related financial disclosures*[3].

Having a comprehensive set of comparable metrics greatly increases the usefulness of non-financial information for comparative analysis by unvestors.

Scope

Only few Member States, namely the small ones with fewer large companies, have expanded the application scope of the Directive. While all countries kept the threshold of 500 employees, only Denmark, Greece, Luxemburg and Sweden require companies with fewer number of employees to disclose. While the definition of "public interest entities" varies in its comprehensiveness, only France also requires non-listed companies with a certain threshold of turnover to disclose. However, in France, which already had progressive non-financial reporting provisions in place, the scope of reporting has been narrowed with respect to listed enterprises with less than 500 employees and those below financial thresholds that are now exempt.[4]

3. Whether to encourage experimentation with integrated reporting as a way to make the EU reporting framework more effective and efficient and if yes how;

We believe that integrated reporting provides a more complete picture of an organisation to its investors and its management. The Directive on Non-Financial Information and accompanying non-binding guidelines already contain elements of integrated reporting and as such, it is a good basis upon which to build.

We therefore support the promotion of integrated reporting in Europe.

We urge the commission to hindering progress due to the delays caused by experimentation without legislative action. We call upon the Commission to start the implementation of the TCFD recommendations and integrated reporting now and use the upcoming review of the EU Non-Financing Reporting Directive as a perfect opportunity to do so. This strong signal will give a clear message to the business community that the time is now for experimentation.

Experimentation, with legislative implementation in parallel will speed up the process to achieving the goal of a financial system that can provide levels of investment required for a sustainable future while giving business enough time to experiment and prepare.

We must not forget that reporting is not intended to be just a burden, but an opportunity for companies to receive more, long-term investment, which will allow them to transition to a more sustainable business model. As stated by the European Systemic Risk Board, the later action is taken to address climate risk in the financial system, the higher the costs associated with the transition to a low-carbon economy.[5] It is therefore in everyone's interest to have high-quality, decision-useful reporting practices in Europe sooner, rather than later.

[3] Climate Disclosure Standards Board (2018). Position Paper*: Materiality and climate-related financial disclosures [PDF]. Available at:* https://www.cdsb.net/sites/default/files/materiality_and_tcfd_paper.pdf.

[4] http://www.purposeofcorporation.org/comparing-the-eu-non-financial-reporting-directive.pdf.

[5] ESRB Advisory Scientific Committee (2016). Too late, too sudden: Transition to a low-carbon economy and systemic risk [PDF]. Available at: https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf.

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4. Whether public corporate reporting does take enough consideration of – and at least is not a hindrance to – technological progress and how to make the best use of these new tools to do more with less.

Currently, financial and so-called non-financial information is considered separately by ESMA, when it comes to digital reporting, which is a hindrance to the integration of non-financial information into corporate reporting.

ESMA is currently developing a European Single Electronic Format (ESEF)[6], as defined by the Transparency Directive(2013/50/EU), which will allow corporate reports to be produced in an easy to use, digital format. While making corporate reporting digital is a very useful development, it only applies to the financial information reported by companies. This means that non-financial information will be continued to be reported in the same way as before. This does not only hold back progress on non-financial reporting, but also separates information that is intended to be used in conjunction with each other.

Given that the future direction of reporting is clearly laid out in Europe, it is imperative that all forms of reporting move in the same direction. This is especially important to ensure policy stability and avoid multiple, incremental changes in the EU legislative framework later on.

We therefore believe that there is work to be done in Europe to ensure equivalence in technological advances and developing financial and non-financial reporting at the same pace and in the same report.

[6] European Securities and Markets Authority (ESMA) (2017). New rules make eu issuers' annual financial reports machine-readable [Online]. Available at: https://www.esma.europa.eu/press-news/esma-news/new-rules-make-eu-issuers%E2%80%99-annual-financial-reports-machine-readable.

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