Non-Financial Reporting for a Sustainable Circular Economy

Towards Greater Policy Coherence?

Summary

Over 6000 European companies are required to publish a report in 2018 on their policies, risks and outcomes regarding environmental, social, human rights and governance matters following the implementation of the EU Non-Financial Reporting (NFR) Directive. The new EU-wide legislation aims to lay the foundation for a new model of corporate reporting that complements financial transparency with environmental and social information necessary to understand a company's performance as well as the impacts of its activities on society.

On 19 September 2017, academics, businesses, investors, civil society experts and EU policy-makers gathered in Brussels for the conference 'Non-Financial Reporting for a Sustainable Circular Economy'. The event aimed at identifying best practices and providing guidance for further development of the EU legislation and the work of the High Level Expert Group (HLEG) on Sustainable Finance. Over 20 speakers discussed the challenges and opportunities presented by the Non-Financial Reporting Directive in fostering a shift towards a sustainable circular economy (see programme here).

The following reflections and recommendations summarise the discussions held at the event:

The capital markets predicament

- The HLEG on Sustainable Finance has highlighted two key misalignments at the heart of sustainability challenge: (1) the trap of short termism (2) failure to translate environmental risks into financial risks for the company. To illustrate the problem, in a recent survey, 50% of financial executives said they would not do a profitable long-term investment if it meant missing their next quarterly earnings forecast.
- This myopic focus is driven by capital markets, where the majority of investors do not integrate environmental, social and governance (ESG) risks and opportunities in their strategy.
- There appears to be a growing willingness to invest in a way that combines stable and good returns with contributing to mitigating environmental and social unsustainability. Nevertheless, there are still economic incentives in place, as well as misconceptions of the role and duty of fund managers and corporate boards, that pose barriers to relevant and reliable ESG reporting and to sustainability-oriented investment.
- Accordingly, the problem is not necessarily that companies do not report ESG information, although lack of relevance and reliability is a pervasive issue. An additional barrier is the unpreparedness of investors to take it into account and invest in data analysis.

The purpose of non-financial reporting

- ESG matters are core to business and have a real and quantifiable financial impact over the long term. In this respect, it was pointed out that 'non-financial' is misleading, and it may be better to frame this information as pre-financial, in the sense that they can transform into financial issues if not properly dealt with at the pre-financial stage.
- Corporations are responsible for a large part of global GDP, but they also contribute substantively to systemic environmental and social risks. Transparency regarding their performance in light of these risks (i.e. their strategies, policies and actual work to mitigate negative and maximise positive impact) is key to address these problems, and contribute to policy coherence for sustainable development.
- Relevant and reliable reporting on externalities has the potential to lead to a necessary discussion with internal and external stakeholders, including shareholders. This multilateral dialogue is a prerequisite for building public trust and cooperation.
- To be meaningful, reporting should give a comprehensive presentation of internal goals and processes concerning the ESG impact of the business.
- The quality of a company's integrated reporting is a strong indicator of how a company is managed.

Integration of financial, environmental, and social performance

- The purpose of the NFR Directive and that of Integrated Reporting ('IR') is to influence business behaviour and strategy. To achieve this, a new understanding of the true financial risk and opportunity to the company in a multi-capital long-term view of the world is crucial.
- Nevertheless, both in the development of the IR concept and the NFR Directive there is a need to further look into the meaning of 'value' and 'non-financial capitals', Corporate reporting needs to account for different ownership models for the capitals: private, community and public.
- Concerning IR, it was noted that it may create a dissonance in companies between: financial and non-financial value; short-term and long-term perspective; and shareholder primacy and interconnectivity of stakeholders. Companies employ different models to address this dissonance but the disconnection between what IR aims and what it is currently achieving remains. Nonetheless, constructive dissent helps companies in their process of critical and integrated thinking necessary to perform a comprehensive and accurate reporting

Materiality

- The definition of materiality is the basis for a meaningful, fair and balanced reporting. The traditional understanding of materiality may be problematic because many environmental and social risks are beyond the horizon of the interest of capital markets.
- The concept of materiality in non-financial reporting should therefore incorporate three dimensions, concentrating on the relevance of the data to:
    a. the system (i.e. environmental and social issues that correspond to planetary boundaries and the social foundation).
    b. the company (i.e. future financial risks or any specific social or environmental goals of the company)
    c. the stakeholders, and in the context of annual reporting, including notably the investors.
- The contribution of different companies and industries to specific environmental and social problems differs greatly. Therefore, it is important that companies focus primarily on measuring and reporting on areas where they both have the greatest impact and face the biggest potential risks. The legislative framework should also be conducive to taking this approach.
- The EU Non-Financial Reporting Directive already includes a requirement to report on impacts and builds on wider responsibility towards stakeholders. However, its definitions are not sufficiently clear and are prone to misinterpretation. Therefore, it would be useful to elaborate what are the key systemic matters, ideally on a sector-specific basis.
- The policy processes should lead us to a standardised reporting framework. Standards need to facilitate the disclosure of material information that is relevant to specific industries and companies business models. In cases where the law does not or cannot specify what is material, companies should carry out a materiality analysis in cooperation with relevant stakeholders and disclose according to it.
- The Sustainable Accounting Standards Board standards have defined what issues are material for a variety of sectors. It would be relevant for the EU to explore this work in order to build a global coherence.

ESG factors and indicators

- Reporting and governance principles and indicators have to be outcome-(performance)-oriented as reporting for the sake of reporting is meaningless. Rather they should be a part of a continuous improvement process.
- The Future Fit Business Benchmark is one example of an attempt to define a complete set of environmental and social goals for businesses based on planetary boundaries and the social foundation, thus enabling the assessment of companies' performance. These goals provide guidance for companies to set up their policies and objectives and include the legal reporting requirements.
- Ensuring full comparability through a common reporting framework may seem impossible due to major differences in the operating context of companies even within the same industry. As a result, reporting with a single normalised KPI (Key Performance Indicator) for each social and environmental impact would oversimplify this complexity.
- The framing of the reporting legislation in terms of comparability may be problematic given how difficult it is to achieve. However, the law may serve well to improve transparency and accountability with the aim to develop sustainability literacy of stakeholders and to create opportunities for a more informed discourse with organisations.
- In this respect, although the indicators are not mature enough for investors to directly compare companies, they can be specified to facilitate the disclosure of data that would make it easier for investors and analysts to assess and build databases based on their own methodology.

- Such indicators should take into account two principles:
    - Life cycle thinking, including global value chains
    - Risks and opportunities should both be reflected, meaning negative and positive impact on a given matter (e.g. in the climate context both greenhouse gas emissions as well as contributions to a global shift to renewable energy)
- Collaboration with academia is crucial to identify and develop sufficiently sophisticated tools to assess and report on ESG issues in a way that serves to implement the United Nations Sustainable Development Goals (SDGs) within planetary boundaries. In this respect, effective reporting must cover full global value chains.

Corporate governance implications

- The definition of materiality explained above and integrated thinking should be reflected in the clarification of the duties of boards of European companies (which has been called for by the HLEG on Sustainable Finance). In line with the primary duty of the board, that is owed to the company, the board should also be expected to determine what are the significant stakeholders of the company and which issues are material for the company long term success
- Corporate reporting on SDGs should be reflected in corporate goverance arrangements and policies in order to realise the potential of reporting to influence corporate strategies and drive sustainable behaviour.
- Private companies as well as those that benefit from special governance arrangements that protect their mission are able to better consider and respond to long term challenges than listed companies facing pressure from capital markets to focus on the short-term. The EU corporate governance and capital markets policies can address this problem in three broad ways:
    - Clarify the purpose of companies and the role and duties of the boards to affirm that the aim is the creation of value in a way that on aggregate is beneficial to society, including the achievement of the SDGs within planetary boundaries.
    - Strengthen and support governance arrangements and tools that help companies to focus on their long-term goals, irrespective or in spite of shareholder pressure.
    - Push investors to integrate long-term ESG concerns in their mainstream strategies and allocate capital towards sustainable business. The clarification of institutional investors' fiduciary duties may be the appropriate first step. Similarly, policies should focus on the role of rating agencies in order to strengthen the connection between social, environmental, and financial performance, avoid isolating ESG considerations in niche products and markets and ensure protection against greenwashing and SDG washing.

Organisers

The conference held on Tuesday 19 September at the Norway House was organised by:

- The SMART project studies the barriers and drivers for market actors' contribution to the UN Sustainable Development Goals within planetary boundaries with the aim of achieving Policy Coherence for Development. SMART is funded by the European Union under the Horizon 2020 programme, grant agreement 693642.
- Frank Bold is a purpose-driven law firm leading the Purpose of the Corporation Project, an open-source platform that brings together leading experts and organisations interested in promoting the long-term health and sustainability of publicly listed corporations.
- The Modern Corporation Project at Cass Business School provides the academic basis for the Purpose of the Corporation Project.