REVISION OF THE NON-FINANCIAL INFORMATION REPORTING DIRECTIVE (NFRD)

AFEP POSITION PAPER - FEBRUARY 2020

French companies have been engaged for many years in putting CSR at the heart of their strategies and are considered world leaders on third-party verified corporate responsibility reporting. They present the highest level of non-financial information and can provide a legitimate and experienced-based contribution to the Commission's work on the revision of the 2014 Directive.

Key messages

- **A harmonised non-financial reporting framework developed under EU leadership** is needed to stop the proliferation of various public or private reporting initiatives which are not aligned and make reporting extremely time-consuming and confusing for corporates. The latter are indeed confronted with numerous questionnaires and ratings, based on different methodologies and definitions.

- The **future EU standard of non-financial information** should aim at sufficient convergence with existing reporting initiatives and be based on their best practices. From the start of the process, it should include a dialogue with other major jurisdictions and with major extra-European investors to make sure that it is recognised by them, and avoid that EU companies have to comply with several standards when they operate worldwide.

- **Companies should be put at the heart of the standardisation process.** The non-financial reporting framework needs to be elaborated in a fully transparent way and in close collaboration with companies to make sure it is operational and reflects the sustainability policies implemented by companies. The governance of the standardisation body should reflect European values (e.g. transparency, fairness and inclusion of all stakeholders). The decision-making process should not be in the hands of a single actor or group of interest.

- **Non-financial reporting obligations should be extended to non-EU companies operating in the EU** if they exceed a certain threshold of global turnover. This is essential to avoid unfair competition.

- Companies do accept to **disclose in non-financial reports how they define materiality,** and which processes they have put in place to identify their material environmental, social and governance (ESG) issues.

- However, **companies need to remain in control of the definition of what is material information** according to their specific activity and sector. They are totally **opposed to the introduction of an obligation to produce a negative statement**, explaining why certain issues are considered as not material, which would indeed lead to illegible reports and a bureaucratic box-ticking approach of materiality.

Background

Non-financial information published by companies on the social and environmental impacts of their activities is today in the centre of attention for multiple reasons.

Faced with the growing importance of environmental, social and governance challenges, EU legislation and guidelines request or commend that **companies publish more and more detailed information on sustainability-related issues such as social or environmental risks, particularly in relation to climate change**. The new "**Taxonomy Regulation**" adds a new layer to these obligations, requiring companies to disclose to which extent their turnover, investments and/or expenditures are linked to activities defined in the EU taxonomy. **Investors will moreover have to inform the public about the environmental and social impacts of their investments,** in accordance with the new "**Disclosure Regulation**", and will inevitably turn to companies to obtain the information they will need to provide to the market, thus creating additional burdens for companies.

Standardisation of non-financial information

Addressing the question of a **harmonised reporting framework for non-financial information is therefore urgent** to prevent stakeholders from working with different methodologies and definitions, which make comparison difficult and force companies to answer numerous questionnaires.

It is hard to properly assess responsible business conduct when **non-financial ratings vary so widely**. A research team from MIT Sloan found that the correlation among ESG ratings is on average 0.61 whereas financial ratings are correlated at 0.99[1]. **50 % of overall divergence is explained by measurement divergences**. The comparability of data underlying ESG ratings is therefore key to improve the quality of ratings, as well as increased transparency of ESG rating agencies about their methodologies.

AFEP believes that **Europe should play a central role in building a more coherent system of non-financial reporting** as multiple private initiatives co-exist today without actually converging. Business involvement is essential in this context to ensure that information is meaningful to both businesses and their stakeholders.

In a speech given on 28 January 2020, Executive Vice-President Dombrovskis announced that the European Commission will launch a process to develop a European non-financial reporting standard.

AFEP is in favour of the standardisation of non-financial information under EU leadership. The **following elements are key** to allow the EU to successfully take the lead on this matter :

- Have a **pragmatic (not theoretical) approach** based on existing best practices,
- Establish **well-balanced and transparent governance** involving companies of different sectors,
- Respect the **principle of materiality** to put an end to ever-increasing reporting requirements,
- Aim at **sufficient convergence with and recognition by internationally recognised reporting initiatives** to avoid that companies have to comply with several standards,
- **Act fast**, as other actors are several steps ahead.

[1] **Aggregate Confusion: The Divergence of ESG Ratings,** F.Berg, J. Koelbel, R. Ribogon, MIT Sloan School of Management, August 2019

Specific comments on the NFRD revision

- **NFRD should be extended to non-EU companies operating in the EU** if they exceed certain thresholds of global turnover. All companies offering products or services in the EU should be subject to the same reporting obligations on sustainability policies and risks. Otherwise, EU companies are likely to be exposed to unfair competition and social or environmental dumping. From a legal point of view, there are **numerous EU regulations that already apply to non-EU companies**, such as Regulation (EU) N°679/2016 on data protection, or Directive 2017/828/EU on the encouragement of long-term shareholder engagement.[2]

- The **verification of non-financial information by independent third parties** should provide for a **plurality of competent organisations** (not only auditors), which have been **explicitly accredited** for verifying social and/or environmental information published by companies. A rigorous process of accreditation of these independent third parties by one of the signatories of the European Accreditation Multilateral Agreement (EA MLA), should be put in place in order to guarantee the quality, legitimacy and credibility of such verifications. It should be made clear that **non-financial verification is very different in nature from financial audit**, as the information to be verified is different, and often qualitative. Financial auditors are therefore not automatically competent in the field of non-financial verification. If they wish to verify non-financial information, they should beforehand demonstrate their competency in this domain, just like any other candidate for accreditation.

- The **principle of both financial and non-financial materiality** should be clearly referred to as the guiding principle for corporate disclosure on non-financial issues, in order to avoid box-ticking and information overkill. The necessary flexibility allowing each company to define its own material issues may be counterbalanced by increased **transparency on the methodologies** applied by companies to define which environmental or social issuers are considered material. However, the **obligation to produce a negative statement explaining why certain issues are considered as not material is unacceptable** for AFEP as it would lead to a huge additional burden and box-ticking exercise without any added value.

- When implementing the revised NFRD and the future EU non-financial reporting standard, the EU should provide for **sufficient transition periods** to allow companies to adapt their methodologies, internal data collection and consolidation processes. Most EU companies have indeed set up their proper methodologies, indicators and data collection processes. It will require important human and financial resources to change the way non-financial reporting is being carried out and to train employees accordingly.

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About AFEP

Since 1982, AFEP brings together large companies operating in France. The Association, based in Paris and Brussels, aims to foster a business-friendly environment and to present the company members' vision to French public authorities, European institutions and international organisations. Restoring business competitiveness to achieve growth and sustainable employment in Europe and tackle the challenges of globalisation is AFEP's core priority. AFEP has around 113 members. More than 8 million people are employed by AFEP companies and their annual combined turnover amounts to €2,600 billion.

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[2] Numerous other pieces of EU legislation with an extended territorial scope of application can be mentioned, such as Directive 2012/19/EU on waste electrical and electronic equipment; Directive 2011/61/EU on Alternative Investment Fund Managers; Timber Regulation 995/2010/EU; Directive 2008/101/EC including aviation activities in ETS; Directive 2005/35/EC on ship-source pollution and on the introduction of penalties for infringements; Regulation (EC) No 391/2009 on common rules and standards for ship inspection and survey organisations; …

AFEP is involved in drafting cross-sectoral legislation, at French and European level, in the following areas: economy, taxation, company law and corporate governance, corporate finance and financial markets, competition, intellectual property and consumer affairs, labour law and social protection, environment and energy, corporate social responsibility and trade.

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