Non-Financial and ESG Reporting: A New Era of Sustainability Reporting?

Executive Summary

- Current market developments indicate that the pressure on reporting entities to disclose **material, balanced and comprehensive** ESG information will continue to increase.
- The European Commission published additional guidelines on the disclosure of **climate-related information** based on the recommendations of the TCFD.
- The **EU Taxonomy Regulation** will oblige corporates in the scope of the non-financial reporting directive to publish the proportion of their turnover, CapEx and OpEx associated with taxonomy-aligned sustainable assets, products or activities.
- The European Commission is currently reviewing the non-financial reporting directive and is expected to propose a **non-financial reporting regulation** by the end of 2020.

In the fast paced world of sustainable finance regulation, the European non-financial reporting directive 2014/95/EU ("**NFRD**") is the dinosaur: Introduced in 2014 and transposed into Luxembourg law in 2016, its ESG reporting requirements have become a familiar part of the annual reporting exercise. However, recent developments indicate that the true transition in the field of non-financial reporting is yet to come.

I. Background

Since January 2017, certain large undertakings are required to provide ESG and diversity related disclosures under the Luxembourg law of 23 July 2016[1]. The high-level requirements of the law were accompanied by non-binding guidelines of the European Commission published in July 2017[2], recommending as key principles that the information provided should be:

- Material,
- Fair, balanced and understandable,
- Comprehensive but concise,
- Strategic and forward-looking,
- Stakeholder oriented, and
- Consistent and coherent.

With the launch of the EU Action Plan on Sustainable Finance in 2018 and the introduction of the EU Green Deal in 2020, ESG reporting has become critical for all major players in the financial market. Reporting entities should get ready for a new era of sustainability reporting.

II. Additional guidelines by the Commission

In June 2019, the European Commission provided supplemental non-binding guidelines focusing on the disclosure of climate-related information[3]. These guidelines seek to fill the gap in climate-related data by encouraging reporting entities to provide **material, sufficient, reliable and comparable** information on the financial and non-financial impact of climate change on

[1] Luxembourg law of 23 July 2016 on the publication of non-financial information, available here: http://legilux.public.lu/eli/etat/leg/loi/2016/07/23/n19/jo

[2] available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017XC0705(01)

[3] available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019XC0620(01)

the entity as well as the entity's impact on climate change. The guidelines are based on the recommendations of the Task Force on Climate-related Financial Disclosure (TCFD) established by the G20's Financial Stability Board and thus benefit from international recognition.

"Given the systemic and persuasive impacts of climate change, most companies […] are likely to conclude that climate is a material issue."
European Commission, Guidelines of June 2019

While these guidelines are, at this stage, non-binding, entities in the scope of the NFRD should take this development seriously. Assessing their climate change impact and climate change's impact on them in line with the guidelines will be a difficult task and require both time and training. In the meantime, the European Commission is successfully promoting incentives to comply voluntarily by massively pushing investors' demand for such information. Opting out of climate-related disclosure will become increasingly difficult and the quality standards applied to such disclosure will continue to rise.

III. Increasing scrutiny of the regulators

National supervising authorities continue to closely monitor and review the non-financial reports published by issuers. It is highly likely that their recommendations will influence the Commission's proposal for a new regulation.

In February 2020, the CSSF published its second report[4] focusing on the quality of the disclosure compared to the key principles introduced by the Commission's 2017 guidelines. The CSSF concluded that the information provided by the 28 issuers it reviewed lacked sufficient materiality and balance. Furthermore, the CSSF sees room for improvement regarding:

- the incorporation of sustainability criteria in the company's business model,
- the due diligence process, and
- the identification of the key ESG risks.

The increasing scrutiny by the CSSF is not specific to Luxembourg, but a general trend in Europe. The French regulator AMF, for example, issued its fourth report on ESG reporting in November 2019[5]. This detailed report also criticized issuers for failing to focus on material information only. Noting the lack of comparability of ESG reporting, the AMF report further aims at providing additional guidelines to French issuers.

"[The CSSF] regrets that unfavourable aspects are omitted at least nine times out of ten. […] Issuers are urged to present a more fair and balanced view of their activities."
CSSF, Report on non-financial information (FY 2018)

IV. Next legislative steps

1. EU Taxonomy Regulation

One cornerstone of the EU Green Deal will be the new EU Taxonomy Regulation (Taxonomy) which was politically agreed on in December 2019[6]. The Taxonomy details economic activities which contribute substantially to specific environmental objectives and do no significant harm. It is expected to influence the entire financial sector, but will be of particular relevance for corporates under the NFRD: As a last minute change during the political negotiation, it was agreed to extend certain reporting requirements under the Taxonomy to them.

Non-financial entities in the scope of the NFRD will be obliged to disclose the proportion of their

[4] available here: http://www.cssf.lu/fileadmin/files/Publications/Communiques/Communiques_2020/C_examination_non-financial_information_published_2018_170220.pdf

[5] available here: https://www.amf-france.org/sites/default/files/2020-02/rapport-2019-sur-la-responsabilite-sociale-societale-et-environnementale-des-societes-cotees_0.pdf

[6] final text available here: https://data.consilium.europa.eu/doc/document/ST-14970-2019-ADD-1/en/pdf

- turnover derived from products or services, and
- total investments (CapEx) and/or expenditures (OpEx) related to assets or processes

associated with environmentally sustainable economic activities as defined in the Taxonomy. The Commission will adopt a delegated act further specifiying these obligations by June 2021.

"Sustainability and the transition to a safe, climate neutral and climate resilient, more resource-efficient and circular economy is the key in ensuring long-term competitiveness of the Union's economy."
Recital 4 of the Taxonomy

2. Non-Financial Disclosure Regulation

In February 2020, the European Commission launched a public consultation[7] on how to improve the disclosure of non-financial information. This public consultation which is open until May 2020 is expected to shape the further legislative proposal of the Commission. Before the end of 2020, the European Commission will likely push for a non-financial reporting regulation introducing amendments to the NFRD.

V. Main takeaways for reporting entities

1. Identify **gaps** in your current non-financial and financial disclosure, especially in connection with climate-related risks.
2. Focus on the **quality** of your non-financial disclosure. Only material information should be provided and the disclosure should present an authentic picture of the company's ESG strategy and risks.
3. Prepare for a more **detailed and sector-specific** sustainability reporting in line with the Taxonomy.
4. Engage with your **stakeholders** to get a clearer picture on their ESG and sustainability requirements and needs.
5. Consider participating in the public consultation of the European Commission on non-financial reporting to present your views.

VI. What we offer

GSK Stockmann offers a variety of services in connection with non-financial and ESG disclosure and sustainable finance generally, such as:

- Legal advice on corporate governance set-ups,
- Review and creation of ESG policies,
- Tailor-made in-house trainings.

Please contact us for further information.

VII. Conclusion

A new era of non-financial reporting is on the rise: A strong focus on material information, a clear identification of climate-related risks as well as a balanced and comparable presentation of the company's non-financial performance will be critical. Issuers should get ready for an internal review of their ESG strategies and risks and prepare for a changing regulatory environment in the years to come.

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[7] Participation possible until 14 May 2020: https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12129-Revision-of-Non-Financial-Reporting-Directive/public-consultation

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