Reform of the EU Non-financial Reporting Directive: A Push Towards Future-proof Reporting Obligations

“We need to mobilise at least half a trillion euros per year of additional investments in the EU”, EU Commissioner for Financial Services Mairead McGuinness has been crystal-clear in her public appearances. She has identified the reform of the EU Non-Financial Reporting Directive (NFRD)\(^1\) as “one of the priorities to strengthen the foundations for sustainable investment”. Without reliable, comparable and meaningful sustainability data from companies, investors and banks will not be able to incorporate long-term sustainability risks into their decision-making as well as to redirect needed finances towards sustainable and future-proof investments. This will leave companies blind to major business risks and opportunities in the rapidly evolving economy.

In 2018, the EU Non-Financial Reporting Directive NFRD introduced obligations for large European companies to disclose information on their sustainability risks and impacts. However, as shown by the Alliance for Corporate Transparency\(^2\) research, the quality and relevance of information is still critically poor\(^3\). The EU NFRD therefore is missing its point of legislation. The latest data for instance reveal that only 13.9 percent of companies explain alignment of their policies with science-based targets and only 6.6 percent use a below 2°C scenario in their risk assessment. In Germany, the numbers are 14.8 % for a science-based Paris-aligned target and 7.4% for the usage of a below 2°C scenario\(^4\).

Why is the reform needed?

Similar to financial accounting, sustainability data is becoming essential for effective corporate management of pitfalls and opportunities in a fast-changing world. Customers, investors and banks also start to require such data to evaluate companies’ strategy and long-term viability, and factor them in their business decisions. In particular, they require forward-looking information. Governments and companies alike need to deliver on the commitments they have made in the context of the Paris Agreement and Sustainable Development Goals. However, various studies show that existing reporting is not

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compatible with these goals and that a lack of integration of forward-looking data with financial reports means the information is not sufficiently useful for business decision-making either.

Figure 1: The assessment of the Alliance for Corporate Transparency of climate-related data disclosed by 300 European companies shows that most companies don’t work with and disclose relevant data and information.

What changes will the NFRD reform bring and which topics can we expect to be the main discussion points this year in the EU?

With the reviewed NFRD, the EU Commission will follow up on the Action Plan on financing sustainable growth with the NFRD reform proposal alongside with a renewed sustainable finance strategy until end of Q2/2021. In advance to the revision, 82 percent of business, investors and civil society organisations called for mandatory reporting obligations and the clarification of the legal framework.

10 expected key points of the reform proposal

Below, we outline ten key issues that the Commission is likely to address in the reform. Most critically, the reform will extend the scope of the law.

Expansion of the scope:

1. Currently, the Directive applies to approximately 5,000 thousand companies, which may be extended to an additional range of at least 35,000 large companies, up to 100,000 businesses if

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high-risk medium-sized companies are included in EU-27. Very likely, the NFRD scope will be extended to include all large companies (both those with assets listed on stock exchanges and private) with more than 250 employees (for illustration, that would apply to approx. 12,000 companies in Germany and 0.2 percent of all EU enterprises)⁹;

2. In addition, there is an ongoing debate on small or medium enterprises that have a high impact or face high risks, such as energy producers or importers of high-risk commodities, to be included in the scope of the new obligations with reporting requirements being proportionate to their size and impact and thus avoiding a "one size fits all" approach. With an estimated proportion of 20 – 30 percent of companies in high-risk sectors, this means an additional 41,000 - 62,000 medium-sized companies in EU-27 will also start falling under the NFRD scope (0.2-0.3 percent of all EU enterprises)¹⁰. Depending on the final extension of the scope, 12,000 - 30,500 companies in Germany might fall under the reformed NFRD.¹¹

Mandatory reporting standards:

3. New qualitative criteria for disclosure of forward-looking information on identification of risks and setting the targets.

4. Definition of information needed to understand companies’ climate transition plans, including timeline, intermediary objectives and time horizons, and alignment with the public objectives and science-based targets.

5. Disclosure requirements concerning human rights and environmental due diligence regarding management of risks and impacts in supply chains. The EU NFRD already requires this type of disclosures. However, only 1 out 5 companies fulfils these requirements according to independent findings by the Alliance for Corporate Transparency, Corporate Human Rights Benchmark of the World Benchmarking Alliance, and the German government.¹²

6. Mandatory, but sector-sensitive Key Performance Indicators (KPIs) in the area of climate change (e.g. greenhouse gas emissions Scope 1, 2 and 3), use of natural resources and biodiversity impacts and pollution, and workforce statistics (composition, wages, collective rights).

Other specific topics likely to be included in the reform:

7. Integration of sustainability reporting within annual reports.

8. Governance and integration of sustainability in the corporate strategy.

9. Clarification of the double materiality principle (which refers to both the financial impacts stemming from sustainability topics and corporate impacts on people and the planet).

10. The specification of mandatory assurance.

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Advantages of standardisation

Companies struggle to meet the multiple and sometimes confusing external expectations they face and that they themselves want to support (climate change targets, SDGs, sustainable investment), but need help in order to translate them in practical terms. The EU NFRD framework can provide clarity to pull these different expectations together and provide more certainty for those in business to apply them. Equally, however, in case it fails to set clear minimum standards, it may just reinforce the competition between private reporting initiatives and rating agencies promoting their own standards.

Therein, standardisation of reporting simplifies automatic data collection and reduces costs. It allows banks to include climate risk assessments into their target-setting and supports the integration of sustainability data into corporate strategy by the board. The legislation is an opportunity to simplify the reporting landscape and assist companies in focusing on the right data.

Don’t miss the train

According to Silke Stremlau, member of the managing board at Hannoversche Kassen, it is certain that investment decision-making will change due to greater transparency than today, with investors that can clearly see the differences between companies, their climate impact and future ambitions.13

The clarification of corporate sustainability reporting obligations can address major challenges facing companies and investors alike. It can overcome the current confusing reporting landscape, set focus on data that really matters, and expand the availability of finance for those companies who are leading the way. In the words of Commissioner McGuinness, the reform of the EU NFRD is meant to be a targeted intervention to ensure that “we channel investments into companies that can deliver on our green and sustainable objectives”.

When the NFRD was introduced in 2018, it showed that it was possible for companies to undertake non-financial reporting without undue cost or burden. However, there is recognition that it is still too focused on compliance by producing a report, rather than on generating information, which is useful to internal as well as external stakeholders in managing the sustainability performance of the company for the benefit of all.

Calendar legal reform and implementation in 2021

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<th>JAN</th>
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<td>EFRAG Project Task Force on Non Financial Reporting Standards</td>
<td>Renewed Sustainable Finance Strategy</td>
<td>Sustainable Corporate Governance legislative proposal</td>
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<td>Final report published including recommendations to the EU Commission on the content and structure of future EU standards</td>
<td>Following the 2018 Action Plan on financing sustainable growth, the EU Commission will publish a renewed sustainable finance strategy in the framework of the European Green Deal</td>
<td>The EU Commission announced plans to propose new corporate obligations to carry out human rights/environmental due diligence and clarify director duties on sustainability matters</td>
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<td>New obligations on financial market participants included in SFDR scope to disclose whether and how they consider sustainability risks. Level 1 (principle-based requirements) come into effect</td>
<td>EU Commission publishes text, which is sent to the EU Parliament for political negotiations</td>
<td>Companies covered by NFRD should disclose specific information associated with environmentally sustainable economic activities (Article 8 Taxonomy Regulation)</td>
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<td>European Single Access Point proposal</td>
<td>EU Parliament and Council negotiations</td>
<td>Sustainability Taxonomy</td>
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<td>EU Commission will propose legislation to create a digital access point for sustainability and financial data</td>
<td>Co-legislators should agree on final text for the reform of the EU Non-Financial Reporting Directive and the creation of EU standards</td>
<td>Criteria on climate change mitigation and adaptation come into effect. Delegated acts on technical criteria on water, circular economy, pollution and biodiversity (applying Dec 2022)</td>
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This article is a part of a monthly briefings series on the latest developments on sustainability reporting.

The material has been produced by Frank Bold, coordinator of the Alliance for Corporate Transparency in collaboration with Germanwatch, as key partner in Germany. Responsibility for the contents rests with Germanwatch.