What needs to be reported on sustainability-related governance?

In 2021, the European Commission will present two intertwined legislative proposals aiming to foster integration of sustainability in corporate strategies:

1. The reform of the EU Non-Financial Reporting Directive (NFRD)1 aims to ensure transparency on companies’ sustainability performance to improve corporate accountability and enable sustainable finance (see our previous article here)2.

2. The sustainable corporate governance initiative3 aims to better identify, prevent, and mitigate severe sustainability-related matters in their own operations and value chains as regards to i.a. social and human rights, climate change, and environment.

The combination of transparency and governance incentives, together with the push of responsible investors, will reinforce the market pressure for companies to prioritize sustainability in their core business strategy and thus among management and board to price in material climate and sustainability-related risks.

This is key for effective corporate management in a fast-changing world where governments and corporates alike need to deliver on the commitments they have made in the context of the Paris Agreement, the EU Green Deal and the Sustainable Development Goals. In order to achieve this, companies need to mitigate the adverse impacts on society and the planet, rather than perpetuating the current model of externalising and dissolving responsibilities across global supply chains- and “companies that are ahead in the game will benefit most” as highlighted4 by EU Commissioner for Justice Didier Reynders.

The importance of transparency and sustainability governance: The reason behind the EU Commission’s proposals

The European Commission estimates that at least half a trillion euros in additional investments per year will need to be redirected from business-as-usual to sustainable activities which support the

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objective to reach climate-neutrality by 2050 the latest. The necessary investment opportunities are readily available (see studies by CDP⁵ and EY⁶). However, financial market actors will only be able to make adequate investment decisions, if the “tragedy of the horizon”⁷ is overcome, and businesses and investors will consider longer-term perspectives on companies and investments and how they are affected by climate and sustainability risks. For that to happen, comparable disclosure of relevant data is a prerequisite.

The need for a strategic approach towards sustainability-related governance

For this reason, companies are increasingly targeted by market players such as investors and by law to strengthen their strategic approach towards sustainability-related governance and to take responsibility for sustainability impacts, not only in the area of climate change but also increasingly in the area of human rights. Théo Jaekel, Corporate Responsibility Expert at Ericsson, is crystal clear in his support for the EU plans to introduce mandatory due diligence requirements:

“We need to go beyond disclosure and move to the management of risks. It is important to see this kind of legislation as an opportunity, and not as a burden because it can clarify how the responsibility of companies looks like in the entire value chain in comparison to current uncertainties around how far-reaching responsibility is, and what can we actually expect from companies. If done correctly, it will alleviate these concerns”⁸.

Also the Sustainable Finance Committee to the German federal government recognizes the importance of sustainability-related governance in its final recommendations⁹ that aim to advice the German Government to make Germany a leading hub for Sustainable Finance:

“Due diligence must be designed in such a way as to price in the long-term social and environmental impacts of business activities and giving them greater weight in decision-making”¹⁰.

However, the Alliance for Corporate Transparency’s research on corporate sustainability reporting shows that – especially material and forward-looking – sustainability information is often not fully incorporated in corporate management and, thus, remains invisible to corporate decision makers as well as investors. In addition, from the point of view of investors and lenders, sustainability information is of little value if it is not clear how it is used by the company and reflected in their strategy.

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⁸ Based on statement by Theo Jaaekel (2021) during the webinar “Sustainable corporate governance and non-financial reporting: finding a pathway to policy coherence” provided by Frank Bold and CDSB. https://www.youtube.com/watch?v=BNZTIEy6vxs. Last retrieved 2021-04-06.
Larry Fink, founder and CEO of BlackRock (the world’s largest asset manager), in his notorious annual letter to CEOs, is directly asking companies in their portfolio to “disclose a plan for how their business model will be compatible with a net zero economy” and to “disclose how this plan is incorporated into your long-term strategy and reviewed by your Board of directors.”

Companies do not address and report sustainability-related governance matters sufficiently

Even though a growing number of directors’ associations, business organisations and investors increasingly recognises the urgency of the climate crisis, the need to transform sectors and business models and therefore the need to fully integrate sustainability matters in companies’ business models and risk management, a vast majority of companies does not consider information on sustainability performance.

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12 Illustration by Frank Bold (2021).
by current reporting practices. For instance, an analysis of 1,000 large EU corporations’ non-financial (sustainability) reports by the Alliance for Corporate Transparency\(^{14}\) revealed that, on average, only 14 percent of companies provide insight on the integration of sustainability in core business strategy, board discussions, and performance incentives. Forward-looking information on a company’s science-based pathway to reduce emissions in line with the Paris Agreement goals (companies’ Science Based Targets\(^{16}\)) and its progress is disclosed by less than 10 percent of the companies. Looking at human rights risks that could have a material financial impact on the organization, 43 percent do not identify any risks whereas 31 percent identify a vague risk and 26 percent describe specific risks after all.\(^{17}\) Again, when it comes to reporting on specific actions that a company has taken to prevent or mitigate impacts related to these risks, only 19 percent reveal information on that.

German companies are no exception: while 57 percent out of 100 analysed large German companies indicate how sustainability is integrated in the board’s and senior management’s operations and mandate, only 14 percent reveal how sustainability matters are actually addressed by the board and their decisions. Even 90 percent of these companies do not reveal information needed to understand a company’s science-based climate transition plan towards meeting the Paris Agreement goals and their alignment with public objectives (e.g. the EU objective to reach climate neutrality by 2050 the latest). Similar to the numbers above in regard to human rights risks, 34 percent of German companies describe specific human rights related risks that could have a material financial impact while only 19 percent disclose actions to prevent or mitigate these risks accordingly.\(^{18}\)

How can companies better report on governance?

So far, there are various reporting standards developed by different global reporting initiatives (e.g. Global Reporting Initiative (GRI)\(^{19}\), Sustainability Accounting Standards Board (SASB)\(^{20}\), Climate Disclosure Standards Board (CDSB)\(^{21}\), the UN Guiding Principles on Business and Human Rights, World Benchmarking Alliance\(^{22}\), Task Force on Climate-Related Financial Disclosures (TCFD)\(^{23}\) etc.), which together include over 5,000 highly divergent key performance indicators.

Even though they all include the aspect of corporate governance, they differ in their requirements and reporting formatting, undermining comparability. While the current reporting obligations under the EU

\[^{15}\text{Alliance for Corporate Transparency.}\thttps://www.allianceforcorporatetransparency.org/. Last retrieved: 2021-04-01.\]
\[^{16}\text{“Targets are considered ‘science-based’ if they are in line with what the latest climate science deems necessary to meet the goals of the Paris Agreement – limiting global warming to well-below 2°C above pre-industrial levels and pursuing efforts to limit warming to 1.5°C.” Science Based Targets (2021): How it works.}\thttps://sciencebasedtargets.org/how-it-works. Last retrieved:2021-03-29.\]
\[^{19}\text{GRI (2021):}\thttps://www.globalreporting.org/. Last retrieved: 2021-03-24.\]
\[^{20}\text{SASB (2021):}\thttps://www.sasb.org/. Last retrieved: 2021-03-24.\]
\[^{21}\text{CDSB (2021):}\thttps://www.cdsb.net/. Last retrieved: 2021-03-24.\]
\[^{22}\text{World Benchmarking Alliance (2021):}\thttps://www.worldbenchmarkingalliance.org/. Last retrieved: 2021-03-24.\]
NFRD requires companies to disclose strategic information, it fails to provide clear guidance on how to determine which information is material and how to select relevant data and metrics from existing sustainability reporting initiatives and standards. This, combined with proprietary questionnaires of rating agencies, as well as requests by investors (also covering the supply chain) makes it very difficult for companies to approach reporting and sustainability from a strategic perspective.

Three essentials for disclosure on governance matters

In reaction to these problems, the reform of the EU NFRD (see our previous article here\(^{24}\)) aims to clarify which information should be reported on governance and the integration of sustainability in corporate strategy. The European Project Task Force on Non-Financial Reporting Standards under the European Financial Reporting Advisory Group has recommended in its final advice to the European Commission that future EU reporting standards should include a standard on strategy in three areas:

1.) Business strategy and targets and Board oversight over their adoption and implementation
2.) Determination of relevant sustainability risks and salient issues (double materiality assessment)
3.) Organisation and integration of sustainability in governance

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Business Strategy and Board oversight

In order to understand how a company integrates sustainability at strategic level, and for Boards to have access to relevant data, the following information is critical:

- **Board-approved strategy** to address salient sustainability issues, including specification of:
  a. High-level measurable and forward-looking targets relevant for the prevention or mitigation of risks and impacts for each salient issue identified by the company,
  b. **Financial resources approved** for the implementation of the strategy;
- **Revisions to the company’s business model, strategy and financial planning**;
- Progress report about meeting the targets and challenges, signed off by the Board.

Double materiality determination and due diligence

Integration of sustainability in business strategy needs to rely on a common understanding of which sustainability risks are material. The EU NFRD builds on the ‘double materiality’ perspective, which provides directions to companies on how to identify issues which either:

- already **have or may lead to financial risks** and impacts for the business; or
- represent the areas in which the company **causes, contributes to** or is directly linked by business relationships to **severe impacts on people or the environment** across its value chain.

In this regard, key information is the following:

- **A description of the process and principles applied by the company to determine its material sustainability risk**, including information on how affected stakeholders were consulted (according to human rights due diligence, companies should engage specifically with people who are at risk of harm due to how a company does business, rather than general categories of stakeholders such as customers, communities, etc. The need for engagement is proportionate to the risk and severity of the harm).
- **A description of sustainability issues determined by this process alongside an explanation of why the issues are deemed material** from either the financial or impact perspectives.
- **Details of the company’s exposure to risks or involvement in impacts** for these issues.

Currently, a majority of companies report on issues, which are not relevant from neither the financial nor the impact perspective and provide no information on the materiality determination process. Typically, companies fill their reports with information on philanthropy, volunteering, and other CSR activities, which are additional, rather than linked to their business. Companies’ reports often suggest that topics covered are selected because the company perceives them as being expected by their stakeholders, but fail to explain whether those topics are in any way material.
Sustainability governance and organisation

The extent to which sustainability considerations are integrated across a company’s governance tools underlines its ability to reflect them in business decisions. To ensure and demonstrate to investors that sustainability is integrated, leading international standards such as the TCFD recommendations highlight three priorities:

- **A description of how the determination of sustainability issues based on a double materiality approach is integrated** in the broader enterprise risk management system. Companies need to demonstrate that these systems not only reflect sustainability risks to the company itself, but also risks it poses to affected stakeholders.

- **An explanation of how a company’s sustainability targets and key performance indicators are integrated** in the performance incentives of the management of the company.

- **An evaluation of the expertise available to the Board** to monitor the implementation and review the content of the company’s sustainability strategy. Such expertise should be proportionate to the complexity of the challenges facing the company, and can be ensured by Board Members with relevant subject matter expertise or through an advisory committee composed of independent experts and managers.

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Lastly but not less important as highlighted by the German Sustainable Finance Committee in its final recommendations, for successful implementation and improvement in these areas, qualification requirements for sustainability criteria in statutory bodies are needed: "Without sufficient competencies related to sustainability criteria, companies’ forward-looking risk assessment, and thus their readiness for transformation and resilience, is limited".27

This article is part our series “Full Disclosure: Monthly Briefing on EU Corporate Transparency Regulation”, in which we aim to shed light on the need for and benefits of forward-looking reporting requirements in a changing EU regulatory environment. The series includes to date:


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27 Sustainable Finance Committee to the German federal government (2021-03-29): Shifting the Trillions A sustainable financial system for the great transformation. Last retrieved: 2021-03-29.