Is the EU Clearing the Path toward More Effective Sustainability Reporting?
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By Charlotte Villiers and Georgina Tsagas

This report highlights key features of the European Non-Financial Reporting Directive and the potential changes that may be featured in the forthcoming revised version.¹

Insight for what’s ahead

Companies should keep a close eye on developments this year in Europe relating to ESG reporting, as they can have a direct and indirect impact outside the EU. The Non-Financial Reporting Directive (NFRD), adopted in 2014, has primarily required large companies based in the EU to make disclosures in environmental, social, employee, human rights, and anti-corruption areas. However, among other changes, the forthcoming revisions to the NFRD may broaden the scope of the companies covered to include non-EU companies that are listed on an EU exchange. Companies not currently within the scope of the NFRD should monitor these revisions and prepare for the possibility of being required to comply with the NFRD.

The NFRD specifies what should be covered in the disclosures in each area, but it also provides some flexibility in allowing companies to provide a clear and reasoned explanation of why they do not have policies in these areas. This could provide a model for the new US presidential administration as it considers expanding nonfinancial disclosure requirements. In addition, the European Financial Reporting Advisory Group (EFRAG)—representing major accounting, banking, insurance, and other financial associations in Europe—is currently working on a set of common nonfinancial reporting standards, which will add institutional gravitas to the efforts to develop a more consistent ESG reporting regime.

The NFRD: Context and key features

Corporate sustainability reporting has expanded significantly over the last decade, driven in part by greater investor interest in nonfinancial information, the proliferation of sustainability reporting standards and frameworks, and regulatory initiatives. Among regulatory initiatives, the NFRD has been one of the most significant drivers of sustainability disclosure, and it represents an incremental step toward “mainstreaming sustainability reporting as mandatory rather than optional.” The NFRD can serve as a model for other regulatory initiatives aimed at nonfinancial disclosure.

**Historical context:** Adopted by the European Commission (EC) in October 2014, the NFRD requires certain large companies to include a nonfinancial statement as part of their annual public reporting obligations. In 2018, companies under the scope of the NFRD had to report according to its provisions for the first time. The objective of the NFRD is “to increase the relevance, consistency, and comparability of information disclosed by certain large undertakings and groups across the [European] Union.” The general aim of the NFRD is threefold:

1. to improve the quality of nonfinancial reporting across the EU;
2. to allow greater comparability; and
3. to attract inward investment.

Unlike a regulation, under EU law, a directive sets forth a framework that must be implemented into national law by each member state. This gives member states some flexibility in implementing the minimum requirements of the NFRD, and some states have set more stringent requirements (e.g., lowered the company size threshold) or broadened the scope of information to be reported. Member states were required to transpose the NFRD into national law by December 2016.

The EC published a set of guidelines in 2017 to help companies disclose their environmental and social information in compliance with the NFRD. Additional guidelines were published in 2019 specifically on reporting climate-related information, integrating the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

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3 Recital 21 of the NFRD, 2014/95/EU.

4 See “Regulations, Directives, and Other Acts,” European Union website.


2020 a public consultation took place to obtain input on potential areas for reform. The EC plans to present a revised NFRD this year.

**What entities are covered:** The rules apply to large public-interest companies with more than 500 employees, covering approximately 6,000 large companies and groups across the EU, including listed companies, banks, insurance companies, and other companies designated by national authorities as public-interest entities. However, as mentioned earlier, some member states have implemented the NFRD differently and lowered the employee threshold.

**What information is covered:** The NFRD requires companies to include "a nonfinancial statement containing information to the extent necessary for an understanding of the undertaking’s development, performance, position, and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption, and bribery matters, including:

   a) a brief description of the undertaking’s business model;
   b) a description of the policies pursued by the undertaking in relation to those matters, including due diligence processes implemented;
   c) the outcome of those policies;
   d) the principal risks related to those matters linked to the undertaking’s operations, including, where relevant and proportionate, its business relationships, products or services which are likely to cause adverse impacts in those areas, and how the undertaking manages those risks;
   e) nonfinancial key performance indicators relevant to the particular business.

Where the undertaking does not pursue policies in relation to one or more of those matters, the nonfinancial statement shall provide a clear and reasoned explanation for not doing so."\(^7\)

**How to report:** The NFRD gives companies significant flexibility to disclose relevant information in the way they consider most useful. The NFRD does not require the use of a nonfinancial reporting standard or framework, and it does not impose disclosure requirements such as lists of specific KPIs per sector. For example, companies may rely on national frameworks, EU-based frameworks such as the Eco-Management and Audit Scheme (EMAS), or international frameworks such as the United Nations (UN) Global Compact, the UN Guiding Principles on Business and Human Rights, the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises,

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\(^7\) Public-interest companies are "companies with a significant public interest because of the nature of their business, size or number of employees or corporate status, including banks, insurance firms and listed companies." See *Rules for Statutory Audit of Public-Interest Entities*.

\(^8\) New Article 19a of the Accounting Directive (2013/34/EU), as amended by Directive 2014/95/EU.
the International Organization for Standardization ISO 26000, the International Labour Organization’s Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, the GRI Standards, or other recognized international frameworks.\(^9\)

While the NFRD does not require the use of a specific standard or framework, responses to the public consultation on reform of the NFRD suggest that respondents gravitate to a handful of major frameworks, including the GRI Standards, the Task Force on Climate-related Financial Disclosures (TCFD), the UN Guiding Principles Reporting Framework, and the Sustainability Accounting Standards Board (SASB) (see Chart 1). However, a total of 108 different frameworks and standards were identified by respondents as relevant to the NFRD, a reminder that nonfinancial reporting remains a complex and crowded space.\(^10\)

**Chart 1**

**If there were to be common European nonfinancial reporting standards, most respondents to the consultation think the standards should incorporate principles and content from the GRI and TCFD**

The consultation referred to a variety of existing nonfinancial reporting frameworks and standards. Respondents were asked to select the extent to which they thought it would be important for a common European standard to incorporate the principles and content of each one.

![Chart 1](image)

Note: There were 588 responses to the public consultation.


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9 Recital 9 of the Directive 2014/95/EU.

Comply or explain: The NFRD combines a binding requirement and a voluntary element. Although the NFRD requires a form of disclosure on key issues, companies that do not have policies on the subject matters identified may choose to provide minimal disclosure through the “comply or explain” format, requiring them only to explain why they do not have such policies in place. The flexibility and discretion given to companies in what and how they disclose allows them to report on what is most relevant, avoiding a “tick box” approach to reporting. However, a downside to the “comply or explain” approach is that it can exacerbate the problem of a fragmented reporting landscape.11

Materiality (and “double materiality”): Article 2(16) of the Accounting Directive (2013/34/EU) as amended by the NFRD defines material information as: “the status of information where its omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking. The materiality of individual items shall be assessed in the context of other similar items.” The NFRD adds another element to the materiality assessment of nonfinancial information: “to the extent necessary for an understanding of the […] impact of (the company’s) activity.”

The NFRD guidelines also suggest that materiality has two layers (“double materiality”): financial materiality and environmental and social materiality. Based on the notion of double materiality, companies are expected to disclose not only how sustainability issues may affect them, but also how the company affects society and the environment.

Potential areas for reform

Proposals for revising the NFRD are forthcoming following a public consultation that ended in June 2020.12 Based primarily on responses to the consultation, the following are some potential areas for reform:

Broadening the scope of companies covered. The disclosure requirements of the revised NFRD will likely apply to more companies, as a high number of respondents to the consultation supported expanding the scope. Among respondents, the greatest support was for expanding the scope to large companies not established in the EU but listed in EU-regulated markets (72 percent of respondents supported this option). This was closely followed by support for expanding the scope to large companies established in the EU but listed outside the EU (71 percent) and to all large nonlisted companies (70 percent). This revision is also likely given that some member states have already expanded the scope beyond the NFRD’s minimum threshold.


Expanding the scope of nonfinancial matters. Respondents to the consultation identified about 50 different relevant nonfinancial matters beyond those specified in the NFRD (environmental, social and employee issues, human rights, and bribery and corruption). The top 15 matters, making up 78 percent of the responses, are shown in Chart 2. The most common suggestions include expanding the scope to align with matters included in the Taxonomy Regulation¹³ and broadening the scope of governance matters beyond bribery and corruption. Supply chain, climate change, and tax round out the top five additional suggestions.

Chart 2

Top 15 nonfinancial matters identified by respondents

The consultation asked respondents whether companies should be required to disclose information about any nonfinancial matters in addition to those already specified in the NFRD.

Note: There were 588 responses to the public consultation.


Expanding the scope of categories of nonfinancial information. The NFRD requires disclosure on the following categories of nonfinancial information: business model, policies, outcomes, risks, and key performance indicators. Respondents to the public consultation identified several potential additional categories to include. Of these, the most commonly suggested categories were targets and progress against targets, and climate scenario analysis (see Chart 3).

Chart 3

Top 15 additional categories of nonfinancial information identified by respondents

The consultation asked respondents whether companies should be required to disclose information about additional categories of nonfinancial information in addition to those already specified in the NFRD.

Note: There were 588 responses to the public consultation.

Requiring disclosure of the materiality assessment process. The revised NFRD may require companies to disclose their materiality assessment process, given broad support for this requirement from respondents to the public consultation (72 percent of respondents supported this). In addition, the concept of double materiality may be explicitly added to the revised NFRD, as it currently only features in the 2019 guidelines and not in the directive itself.

Adding sector-specific guidance. Instead of providing for examples vis-à-vis KPIs, a revision to the NFRD may outline a sample of material issues for specific sectors or industries (similar to the approach SASB has taken). Doing so could assist in “measuring” between factors and industries, and might help address the challenges of consistency and comparability. More detailed guidance could also help reduce semantic confusion. Among respondents to the consultation, 80 percent supported the inclusion of sector-specific elements.

Including mandatory provisions for assurance and verification. The use of assurance of nonfinancial information is not currently a requirement of the NFRD or any major reporting framework. However, responses to the public consultation indicate some support for this requirement: overall, 67 percent of respondents agreed that stronger assurance requirements should be introduced. Support for this requirement was higher among users of nonfinancial reports (78 percent) and lower among preparers of nonfinancial reports (59 percent).

Looking ahead: NFRD and the Taxonomy Regulation

The EU Taxonomy Regulation, some elements of which come into force in December of this year, introduces an extensive classification system of environmentally sustainable activities, aimed at providing investors with greater clarity concerning financial products that are presented as sustainable or environmentally friendly. The Taxonomy Regulation, which supplements the Sustainable Finance Disclosure Regulation and supports the EU’s Green Deal agenda, will require companies to disclose the level of environmental sustainability of their funds and pension products. The Taxonomy Regulation primarily focuses on sources of capital, while the NFRD applies more broadly to other types of companies.


However, companies covered by the NFRD will be required to disclose “information on how and to what extent their activities are associated with environmentally sustainable economic activities” according to the Taxonomy Regulation, such as:

- The proportion of their turnover derived from products or services associated with economic activities that qualify as environmentally sustainable; and
- The proportion of their capital expenditure and the proportion of their operating expenditure related to assets or processes associated with economic activities that qualify as environmentally sustainable.

The Taxonomy focuses on six environmental objectives: climate change mitigation; climate change adaptation; sustainable use and protection of water and marine resources; transition to a circular economy; pollution prevention and control; and protection and restoration of biodiversity and ecosystems. Respondents to the NFRD public consultation generally support greater alignment with the Taxonomy Regulation, with 69 percent of respondents agreeing that the NFRD should define environmental matters on the basis of the six objectives of the Taxonomy. Going forward, greater alignment between the Taxonomy and the NFRD is likely.

**Conclusion**

The NFRD has been one of the most significant regulatory initiatives aimed at nonfinancial disclosure. Building on the directive, a Project Taskforce for creating common nonfinancial reporting standards was established by the European Reporting Lab of the European Financial Reporting Advisory Group (EFRAG), and work is under way for producing those standards. The forthcoming revisions to the NFRD, together with those standards, may provide greater clarity and guidance on what and how companies should be reporting nonfinancial information, as well as have a direct impact on companies that are listed, but not headquartered, in the EU. And while the NFRD alone does not resolve the challenges of comparability and consistency in sustainability reporting, it provides a starting point and a model for other regulatory efforts.

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17 See EFRAG, Non-Financial Reporting Standards web page for further information on the ongoing work.
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