INVESTMENT

Making history

Elisabeth Jeffries looks at what effects the first EU directive mandating non-financial corporate disclosures could have on European corporates and investors

WRITTEN BY ELISABETH JEFFRIES, A FREELANCE JOURNALIST

It has been described as historic. The first EU directive mandating non-financial corporate disclosures, due to take effect this year, breaks new ground in corporate reporting requirements. A cynic might describe it as window-dressing. Yet there is a case for lauding its introduction.

Changes

Firstly, it extends the corporate social responsibility (CSR) probe to Europe's furthest boundaries. Mandatory reporting on some environmental, social and governance (ESG) issues already exists in major economies. The UK's 2006 Companies Act, for example, requires UK quoted companies to report greenhouse gas emissions in their directors' reports. France's Grenelle II law obliges many companies listed on the French stock exchange to incorporate information on the social and environmental consequences of their activities into their annual reports. In Germany, a sustainability code known as DNK covers many of the directive's obligations.

But many of the EU's newer members or less developed countries will need to integrate the directive into their statute to introduce their first non-financial reporting rules. At the same time, companies that have withheld information will need to supply it. "It will require 6,000 companies across Europe to disclose certain ESG information, and many of these companies have never done so before," Beyond Business sustainability reporting consultant Elaine Cohen says.

The new law also makes a major leap from previous ESG reporting rules, which mainly targeted the extractive industries as part of a clampdown on corruption and bribery. Companies in the sector had to disclose more information about payments to governments. One implicit aim was to stop EU businesses from trying to bribe officials in resource-rich developing countries. The illegal sale of hardwood, for example, would then be used to fund civil conflict within that country. "In some countries, this might be the only way the local population could find out what their government was up to," an executive at a professional accounting organisation observes.

The directive broadens and strengthens the existing accounting law, which set quite high-level conditions open to interpretation. It covers a far wider range of corporate responsibility concerns than the previous legislation, as well as much national legislation. This includes bribery, human rights, employee diversity and environment.

But as a tool for greater transparency to guarantee accountability to the general public, its merit will take many years to prove. The directive originally proposed to cover a far wider spectrum of business activity, aimed at around 20,000 companies, but this intention was diluted during the legislative process.

Meanwhile, accounting processes continue to be dissatisfactory. Social or environmental impacts are most commonly buried in the hard numbers in the financial statements.

Typically, those numbers only indicate responsibility when misconduct is exposed. "The costs associated with being found out relate perhaps to general loss of reputation, reduced sales and potential litigation. Litigation risk can later turn into contingent liabilities or recognised provisions," London School of Economics professor of accounting Peter Pope points out.

Bad news may leave a financial scar on the company's profit and loss account despite a clean CSR report, as the emissions debacle last year at Volkswagen showed. Sales in some countries fell while the company's share price halved. Not surprisingly, the underlying software use was not revealed in the company's 2014 sustainability report. Any investor reading it might have found it impressive.

Dense pages printed in a literary style and interesting font suggest thought leadership and Germanic introspection. "It's not about growth at all costs," states one heading. An article entitled *SUVs – where emotion meets reason?* justifies its role in the SUV market through lightweighting and electric vehicle innovation.

As Cohen states, the report set high standards. The Global Reporting Initiative, a standards organisation, confirmed it included material disclosures. "Volkswagen disclosures have been consistently in line with reporting expectations and the company received recognition from many ranking and rating organisations including the Dow Jones Sustainability Index", she says.

Clearly, the new legislation in itself will not put a stop to commercial conjuring tricks or pollution incidents. Mainstream auditing procedures may shine a bright beam on particular activity while failing to detect dark matter surrounding it. They may focus on final sales, for example, rather than operational decisions supporting them. As Pope explains, a sustainability report can well be accurate while presenting the company through a particular lens.

"CSR reports may sometimes reflect the perceptions of the board of directors, whose perspective on actual business practices might not correspond to reality because they don't know the fine detail. Management control in complex organisations can be problematic," he says.

Clearly, the VW case is not the first. Out-of-touch boards have been held responsible for many of the problems that emerged during the 2008 financial crash. The transparency and reliability of the non-financial statement in the management report, when it becomes mandatory, is thus likely to be compromised. The record of previous laws on disclosure also suggests compliance may be limited.

The adoption of the International

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Financial Reporting Standards (IFRS), made obligatory by the EU in 2005, is a case in point. "Enforcement of IFRS in financial reporting is much patchier than policy makers had intended. It is a major problem," Pope notes. Meanwhile, miscreant directors rarely suffer severe penalties or imprisonment.

Impact

The influence of the law is likely to be indirect, nudging companies to improve their corporate culture, creating a level playing field and raising the standards of member states with lower requirements. "The European Commission's motivation for a directive of this kind is to protect the single market and improve its rationalisation and harmonisation," comments an executive from a professional accounting organisation. A single accounting code will help support that objective now that CSR reporting has become commonplace.

At present, CSR analysts perceive poorer performers through unsubstantiated numbers or shifting methodologies from one year to the next. "A company has many ways of communicating its activities, not just a sustainability report. In general, however, there are certain frameworks and expectations of sustainability reporting at a global level, and it's fairly easy to note if a company is not achieving this expected level of transparency," Cohen says. Now that non-financial reporting is to become law across the EU, it is reasonable to expect those failings to become more evident.

Activists have high hopes for methodology guidelines that are under consultation since mid-January 2016. By embedding a consistent approach, they will help investment analysts detect poor performance more easily. In a statement, the Climate Disclosure Standards Board, an organisation concerned with reporting matters, drew attention to the significance of the directive and the guidelines.

"It is a significant step forward for European and international investors who seek timely, material, comparable and forward-looking information on non-financial risks and opportunities," the campaigning organisation stated. According to its research, failure to adopt the legislation will make such decisions more difficult and costly for investors, and will increase the risks of harming European companies' international competitiveness.

However, non-financial reporting is unlikely to grow full teeth unless ESG matters are fully recognised as material to the business and ESG externalities are incorporated into the accounting system. ■

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