

## European Combined Reporting Alliance for ESG Position Paper

It was agreed that a joint response to the European Commission on this stakeholder process would be helpful, along with a call for an EU-funded programme to develop on the workshops for the economic stakeholders.

An alliance of economic and capital markets stakeholders joined forces to help improve the outcome from the series of workshops held from September 2009 to February 2010 by the European Commission to address environmental, social and governance (ESG) disclosure. It is apparent that there are common interests and concerns. The ideas of company value and of connected or combined reporting, which are material and strategic, are at the heart of our vision for ESG disclosure.

### General Position

As a general strand and as representatives of economic and capital market stakeholders, we:

- favour a combined approach to corporate reporting as one of the levers to embed sustainability in corporate strategy & management practices;
- support a mandatory regulatory approach to ESG disclosure and reporting at the European level, as long as it provides companies with some latitude of choice in terms of content;
- consider that there is no appropriate ESG disclosure and reporting framework presently fully meeting the needs of capital markets actors (namely companies and investors), while non-financial disclosure and reporting frameworks currently in progress are promoting the idea of combined reporting;
- acknowledge the fact that the time has come to unite the efforts of the scattered and international European initiatives on ESG disclosure & reporting, and to support the efforts of international connected reporting initiatives such as the International Connected Reporting Committee<sup>1</sup>.

### Context

***Information is only relevant if it is used in decision-making and, from an ESG perspective, changes decisions taken towards more sustainable outcomes***

A key question is, therefore, who is the information being reported for and what decisions are they taking as a result? Answering this question influences the form and type of disclosure and reporting that would be required:

1. Providing the information set that enables an assessment of a company's value now and in the future;
2. Ensuring that reporting provides the information set to enable stakeholders to assess a company's contribution (positive and negative) towards the achievement of a sustainable economy and society in the context of its ability to take action.

<sup>1</sup> Launched by The Prince's Accounting for Sustainability Project in December 2009.

There is an overlap between these two different perspectives – if the economy and society are not sustainable into the future, many companies will also not be sustainable and value will be negatively impacted. This is of particular relevance to universal owners such as pension funds and insurance companies who are exposed to longer-term trends within the economy as a whole, rather than the performance of individual companies. In this sense, there is an incentive for these classes of investors to ensure that companies are taking the steps necessary to transition towards a sustainable economy and rewarding those companies that do so.

The primary objective is the transition to a sustainable society, however, part of that transition has to be to enable economic actors to better price in the risks and opportunities associated with sustainability trends through better and more relevant comparable disclosure and reporting. This will involve refocusing disclosure requirements to provide greater clarity in relation to the significance of ESG and other issues rather than increasing the volume of disclosure.

Although developing a common set of frequently used indicators is not the whole answer, improving standardisation and therefore comparability for core metrics (at international, EU, national and sector levels) is a fundamental enabler for ESG factors to be taken into account in investor decision-making and therefore part of the step-change that needs to happen.

However, the inclusion of indicators is not enough. A narrative framework providing the context of value creation for the company needs to be clearly provided for with the indicators as supporting evidence of the contextual narrative story.

***Focusing on ESG information is our primary target***

In financial markets a common concept is the distinction between financials i.e. data and information typically but not exclusively presented in the so-called primary financials balance sheet, and income and cash-flow statements on the one hand, and non-financials. We use the term ‘non-financial’ to refer to information relevant to the assessment of economic value, but which does not fit easily into the traditional accounting framework. Other terms such as ‘extra-financial’ are also sometimes used to describe this information. It encompasses topics such as market data, data on brand, intellectual capital, performance on intangibles, in brief areas typically not or only indirectly reflected in primary financial statements.

Whilst we acknowledge that there is no exclusive list of non-financial areas and that understanding various non-financial issues is essential to a well-informed and thorough investment analysis, first and foremost we are focussing its scope on ESG i.e. issues in the area of environment, social and corporate governance performance.

We agree that disclosure of ESG should form the first step of integrating non-financial information within classic financial valuation. In the future additional sets of data reflecting other areas classified as non-financial information may well become subject to disclosure initiatives. Some of these initiatives are already taking shape.

***ESG reporting should be made mandatory as voluntary approaches have shown their limits***

The Modernisation Directive (2003/51/CE) of June 18<sup>th</sup> 2003<sup>2</sup> favours the “comply or explain” approach, Article 1- 14 of the above mentioned Directive, changing Article 46 of the Fourth Directive (78/660/CE) of July 25<sup>th</sup> 1978, stipulates:

[...] The consolidated annual report shall include at least a fair review of the development and performance of the business and of the position of the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

The review shall be a balanced and comprehensive analysis of the development and performance of the business and of the position of the undertakings included in the consolidation taken as a whole, consistent with the size and complexity of the business. *To the extent necessary for an understanding of such development,*

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<sup>2</sup> Which introduced certain changes to the Fourth and Seventh Directives.

*performance or position, the analysis shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters.[...]*

Although the inclusion of non-financial, thus ESG, indicators is compulsory to the extent they are relevant in explaining the company's development, performance or position, we do not see how in the present circumstances non-financial disclosure (information) & reporting (indicators) could not be relevant to any company.

By aligning the status of non-financial and financial disclosure & reporting, the Directive also pinpoints 3 major aspects:

1. It defines the scope of ESG disclosure & reporting, i.e. the scope of consolidated accounts;
2. It defines the location of ESG disclosure & reporting, i.e. in the annual report<sup>3</sup> which is a document which has to be formally approved by the Board and the Annual General Meeting of the company<sup>4</sup>;
3. It unveils the content of ESG disclosure & reporting, i.e. the importance of focus by industry.

## Recommendations

### **Principle based versus rules based: Reinforcing the existing Directive by focusing on content**

Because ESG disclosure & reporting is still in infancy, any further European regulatory approach should combine the 2 approaches. However fixing a deadline for defining a generally accepted framework for the content of ESG disclosure & reporting is key. We feel that the existing Directive is sufficient (principle based approach); it should however be completed by a recommendation which would:

1. design the guidelines which should be followed to achieve an efficient ESG disclosure & reporting framework (materiality, relevance of ESG issues, comparability, etc.);
2. define the process by which the content of ESG disclosure & reporting shall be designed;
3. decide on a deadline by which a first set of cross-sector and industry indicators should be agreed upon by the stakeholder community;
4. support the whole process by a strong communication campaign and supporting explanatory tools.

### **Working with the right frameworks...**

In the field of KPIs, there is no unanimously recognised framework as of today; it has to be « invented » or more appropriately formalised through a convergence process of the different existing international and European initiatives<sup>5</sup>. That convergence is a key purpose of our combined reporting submission and intention to work together in the future.

From our field experience, the generally accepted framework must distinguish between two sets of ESG indicators:

- "Key Performance Indicators"<sup>6</sup> - indicators which demonstrate the material contribution, whether direct or indirect, of sustainable practices to the organisation's economic and financial performance and therefore to its value creation;
- "Social license to operate indicators" - indicators which reflect what civil society requires from economic and market organisations as their contribution to the societal issues of tomorrow.

<sup>3</sup> By positioning ESG disclosure & reporting in the annual report, the Directive aligns the status of extra-financial reporting with the status of financial reporting, consequently implying the same level of external third party control, in particular Auditors, and sanctions by regulatory bodies.

<sup>4</sup> In some cases, the annual report has to be reviewed, although not approved, by the "Employees' Council".

<sup>5</sup> Including EFFAS, The Prince's Accounting for Sustainability Project, European Laboratory chaired by Telecom Italia & Lloyds Banking Group and facilitated by CSR Europe, WICI, GRI and CDP/CDSB.

<sup>6</sup> Which precisely meet the requirements of companies, investors (the capital markets stakeholders) and employees.

***The scope of ESG Disclosure & Reporting: All companies or organisations, on an annual or consolidated basis when relevant, calling upon the resources of capital markets***

The question of scope covers in fact two key questions:

1. Which companies or organisations should be within the scope of mandatory disclosure, given the present state of development of ESG Disclosure & Reporting?
  - Mandatory reporting should primarily apply to large<sup>7</sup> companies or organisations;
  - Public interest entities including listed companies; state-owned organisations; as well as large cooperative organisations; should be the primary targets.
2. For each company or organisation, what should be the geographical scope?
  - The geographical scope should be aligned with the scope of financial reporting, therefore consolidated whenever appropriate;
  - However, at that stage we are not in favour of having the subsidiaries of a Group or companies over which the Group has a significant control to report as such when the Group is subject to ESG Disclosure & Reporting.

***In terms of information assurance, the status of ESG KPIs & information should be aligned with the status of financial information & reporting***

As described in the Modernisation Directive the auditor of the financial statements already reviews and reports on the consistency between the financial statements and the annual report. As such at a very high level, ESG information is already in the scope of the auditors whether they carry out audits or perform risks review and diligences. Given the importance of connected reporting on financial and non-financial including ESG-information for the long term financial performance of an organisation we recommend that KPIs that are reported in the annual report are subject to an appropriate level of assurance. This will improve the quality of this information and provide investors with confidence in relation to completeness and reliability of disclosures made.

***Which process to achieve a generally accepted framework by 2012?***

As pointed out earlier the challenge is more building consensus between the different interested parties than creating content ex nihilo.

Given the fact that different stakeholders have different interests and therefore different requirements in terms of disclosure content and format, we suggest the Commission:

1. to create a high level working Group composed of representatives of the major stakeholders<sup>8</sup> within the categories implicitly defined by the EU ESG Disclosure Workshops<sup>9</sup>;
2. to “decouple” the working process, i.e. organising the workflow in sub-groups of stakeholders sharing the same interests and objectives (the primary split between economic & capital markets stakeholders, and civil society stakeholders, the trade unions having an in-between situation);
3. to fix a deadline by which the disclosure & reporting framework should be agreed upon between the stakeholders as a first step to be flexibly improved;
4. to input to and align work with international developments to ensure that common international requirements are developed and adopted.

<sup>7</sup> The concept of a large organisation should take into account simple criteria, such as the size in terms of staff, sales..., total assets, the fact of calling upon the resources of the capital markets... or a combination of those and its definition should be decided after making simulations using different criteria.

<sup>8</sup> FEE and ICGN were part of the discussion leading to this position paper and therefore would be assumed to be included.

<sup>9</sup> Companies, Investors, Civil society & media, Trade Unions and Public Administrations.

## Terminology

### Disclosure

The provision of any information regardless of its content, whether narrative or quantitative, and its format (interview, policy document, label, annual report, management report, indicators, etc.).

### Reporting

In the context of this submission we use the word reporting to refer to the provision of information within documents such as annual reports etc.

### Financial / Non-financial information

*Financial information* covers data and information typically but not exclusively presented in the so-called primary financials balance sheet, or income and cash-flow statements.

*Non-financial information* refers to information relevant to the assessment of economic value, but which does not fit easily into the traditional accounting framework. Other terms such as 'extra-financial' are also sometimes used to describe this information; it encompasses topics such as market data, data on brand, intellectual capital, performance on intangibles, in brief areas typically not or only indirectly reflected in primary financial statements.

### ESG

Any issue relating to environmental, social & governance matters. In our view, ESG information is a large subset of non-financial information.

### Intellectual capital

Intellectual Capital/ Intellectual Assets – IC/IA – is the internal (competencies, skills, leadership, internal procedures and routines, know-how, research capacities, organizational capabilities, etc.) and external (image, reputation, brands, alliances, customer relationships and satisfaction, etc.) stock of intangibles recognized by and "available" to an organisation, which can be transformed by the entity into a corporate performance affecting sustainable stakeholder's value through the pursuit of sustainable competitive advantages. Intangibles become IC/IA only when they are durably and effectively internalized and/or appropriated by an organisation.

### SRI

Socially and Responsible Investment (SRI) - Any investment & engagement process which takes ESG criteria simultaneously into account in its investment / divestment choices.

### KPI

Key Performance Indicators which demonstrate the contribution, whether direct or indirect, of sustainable practices to the organisation's economic and financial performance and therefore to its value creation. KPIs are meant to be included in the corporate management and control systems.

### Social License to operate indicators

Indicators, which reflect what civil society requires from economic and market organisations as their contribution to the societal issues of tomorrow.

A brief presentation of the founding members of the European Combined Reporting Alliance for ESG



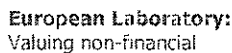
European Federation of Financial Analysts Societies  
[www.effas.net](http://www.effas.net)

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national investment professional societies. It comprises 25 members representing more than 14,000 investment professionals in the areas of equity and bond research, asset management as well as investment advice. EFFAS Commission on ESG (CESG) is a working group within EFFAS which consist of 12 investment professionals from 8 different European markets. CESG acts as the sounding board and expert panel of EFFAS on all issues on Environmental, Social and Governance.



European Sustainable Investment Forum  
[www.eurosif.org](http://www.eurosif.org)

Eurosif (the European Sustainable Investment Forum) is a pan-European group of national Social Investment Fora (presently BELSIF, Forum Nachhaltige Geldanlagen, Forum per la Finanza Sostenibile, Forum pour l'Investissement Responsable-FIR, SpainSif, SWESIF, UKSIF, Vereniging van Beleggers voor Duurzame Ontwikkeling-VBDO) whose mission is to **Address Sustainability through Financial Markets**. Current member affiliates of Eurosif include pension funds, financial service providers, academic institutes, research associations and NGO's. The association is a not-for-profit entity that represents assets totalling over €1 trillion through its 100 affiliate memberships.



European Laboratory: Valuing non-financial performance  
[www.investorvalue.org](http://www.investorvalue.org)

The European Laboratory was convened under the umbrella of the European Commission-sponsored European Alliance for CSR in 2006. It is a compact of companies and stakeholder organisations led by Telecom Italia and Lloyds Banking Group, facilitated by CSR Europe. The Laboratory is supported by a parallel research project of leading European business schools funded by the European Academy of Business in Society. Its focus is the relationship between companies and investors, developing a framework for company and investor dialogue informed by the research and stakeholder consultation supported by EFFAS. The framework is based on core areas of non-financial performance that have demonstrable links to financial outcomes and are wholly or partially dependent on a range of ESG factors. The Laboratory will finalise the framework and make recommendations to companies, investors, and other stakeholders, including the European Commission, in a report to be published in May 2010.



The Prince's Accounting for Sustainability Project  
[www.accountingforsustainability.org](http://www.accountingforsustainability.org)

Accounting for Sustainability is bringing organisations together to develop practical tools to enable environmental and social performance to be better connected with strategy and financial performance, and thereby embedded into day-to-day operations and decision making. The Prince's Accounting for Sustainability Project works with businesses, investors, the public sector, accounting bodies, NGOs and academics to develop practical guidance and tools for embedding sustainability into decision-making and reporting processes. To date, the project has involved the collaboration of more than one hundred and fifty public and private sector organisations.



Railpen Investments  
[www.railpen.co.uk](http://www.railpen.co.uk)

Railpen Investments is a subsidiary of RPMI which oversees assets worth approximately £18 billion on behalf of the Railways Pension Trustee Company Limited, the corporate trustee of various UK railway industry pensions' funds with over 350,000 beneficiaries



World Intellectual Capital/Assets Initiative  
[www.worldici.com](http://www.worldici.com)

WICI Europe is the European regional jurisdiction of the WICI (World Intellectual Capital/Assets Initiative), the world's business reporting network, that is a private/public sector global collaboration aimed at improving corporate information - with a focus on non/extra financial information - for a more effective decision making in a value creation perspective. The founding members are six organizations based in Europe, US and Japan. WICI Japan is another regional representational body of the WICI global network.