Non-Financial Reporting:
The impact on the relationship between Boards and Auditors

15 March 2016

REPORT

On 15 March, ACCA, ECIIA and ecoDa held a joint conference in Brussels on the theme of **Non-Financial Reporting: The impact on the relationship between Boards and Auditors".** Its goal was to discuss how boards and internal and statutory auditors can cooperate better to ensure effective implementation of the Non-Financial Reporting Directive.

There were keynote speeches by **Turid Elisabeth Solvang**, ecoDa Chair; **Nicolas Bernier-Abad**, DG FISMA European Commission: **Neil Stevenson**, Managing Director: global implementation, IIRC: and **Richard Howitt**, MEP, sponsor of the Directive.

This was followed by a panel discussion moderated by **Jo Iwasaki**, Head of Corporate Governance, ACCA, including **Paola Schwizer**, Chair of Nedcommunity and ecoDa board member, Chair of the Audit & Risk Committee of Credem S.p.A. and Inwit S.p.A., **Farid Aractingi**, VP Audit, Risk and Organization Renault, Chairman Renault Consulting, Chairman IFACI and Vice President ECIIA; **Noémi Robert**, Senior Manager, Federation of European Accountants (FEE); **David Szafran**, Lawyer at Law Square and Chair of ISAR 30th session at UNCTAD; **Carl Rosen**, Vice-Chair of Better Finance and Head of State Ownership and Innovation at the Swedish Ministry of Enterprise.

The conference was concluded by **Henrik Stein**, Group Audit Director DZ Bank and President, ECIIA.

Key themes of the debate :

- The overarching goal of the NFR directive - and its forthcoming guidelines - is to sustain better companies that will last. It is a move that is necessary because it is beneficial for companies and for the wider economy; but the new framework will not be excessively prescriptive. It is not the intention of the European Commission to tell companies how they should manage themselves.
- The implementation of the Directive should be seen as a positive opportunity for businesses, providing that reporting is linked clearly to strategy and decision-making at board level.
- The Directive will require close collaboration between auditors, audit committees and boards.
- Investors should be ready to challenge companies on relevance, completeness and quality presentation of their annual reports.
- It was important for companies to develop integrated thinking to improve the effectiveness of their strategy and execution.

Highlights

Turid Elisabeth Solvang, ecoDa Chair

- These are times of turbulent change. It is affecting not only our products and services but also the way we do business and even the very fabric of our society. Taking shortcuts to short-term profit can be tempting, but missteps can set companies on the road to failure. At the same time, long-term is not as long as it used to be. It is the responsibility of the board to ensure that the company's long-term positioning receives the required attention.
- By December 2016 Member States are due to transpose the Non-Financial Reporting Directive which aims to drive better performance of companies on environmental and social matters. The European Commission has launched a consultation on non-binding best practice guidelines. We need to determine what these guidelines should address. It is important to ensure that company provides shareholders and other stakeholders with relevant information.
- Like regular financial reporting, non-financial reporting must relate business value and long-term value creation based on clearly defined KPIs One of the main tasks is to identify clear ownership of reporting while linking it with business results and long-term

value creation. The ultimate responsibility rests with the board. It must ensure that the report meets the intention of the Directive and is relevant to the company's operations.
- The number of compliance tasks asked of the board is increasing steadily: but in the light of the financial crisis and recent corporate scandals, the interests of society, shareholders and other stakeholders must take priority.
- If companies compromise the trust of society, customers and shareholders will migrate elsewhere. As volatility increases, the value of that trust will multiply. Businesses need to value their reputation and stakeholders' trust as core assets and treat them as such. For this reason the content of non-financial reporting is going to be so important going forward. Companies should avoid treating this as a comply-or-explain exercise and instead respond to the intention of the regulation.

Nicolas Bernier-Abad, DG FISMA, European Commission

- The objective behind the directive is sustaining better companies that will last. There is already a lot of good practice across Europe : we want to build on that.
- Transparency and communication are business tools. Getting companies more transparent is good for resilience and better performance – it is pro-business legislation.
- The Commission does not want to be excessively prescriptive, and wants to draw on existing practice and existing frameworks: The Directive does not tell companies how they should be managed either. The Directive sets out a disclosure requirement, rather than a 'comply or explain' approach
- The aim is not to create a new report, but to add content to the existing management report regarding environmental and social obligations; action to counter corruption and bribery; and respect of human rights. To explain to the owners of the company what is going on in the business, it is necessary to talk about these things in the same way as talking about profit and loss.
- The Non-Financial Reporting Directive only covers the largest companies - around 6000 across the EU, of which around 2000 are already disclosing such information.

Neil Stevenson, Managing Director, Global Implementation, IIRC

- Businesses have a choice on how they will approach the implementation of the directive. If they use it as a box-ticking exercise, it will not deliver real gains. Through adopting integrated reporting businesses can go step ahead. By complying with the directive businesses can understand how their business is impacting the environment. Through adopting integrated reporting they will begin to think in terms of how this information is impacting their business model and their ability to create value.
- Two key developments that are worth noting: increasing interest from investors in value creation over time and interest from the Financial Stability Board in the issue of climate change and its impact on business. Both developments relate to the core mission of the IIRC.
- We should see the implementation of the Non-Financial Reporting Directive as an opportunity. However, we can only do that if disclosure is connected to strategy and decision-making at board level. Integrated reporting provides a framework for understanding how issues from society and the environment impact an organizations business model, It helps companies understand how they create value over time and the risks that might impact their strategy over the short-, medium- and long-term.

- All too often corporate reporting is conducted in a silo, disconnected from board decisions on risk or real consideration of their impact on the business model. This needs to change. Reporting should be a catalyst for internalising the external factors that pose a risk to the business model. Ultimately, reporting connects to the capital markets and the economic system. Non-financial reporting in that sense can bring great value to business and society.
- The role of internal audit is more important than ever – the Directive creates an opportunity for it to add value in a broader context. The role of the audit committee will also, as a consequence, become more important.
- We should really think about the needs of users and how this directive can be an opportunity to get them to engage much more with strategy and value creation.

Richard Howitt MEP, Rapporteur on CSR

- The Non-Financial Reporting Directive is a good piece of legislation and it will improve European businesses. We shouldn't be interested in only passing laws – we should strive for an effective implementation.
- The Directive also creates opportunities for auditors to work more closely with boards in the wider public interest.
- It is an enabling piece of legislation designed to work out all environmental, social and governance aspects that have an impact on the company, how they are managed and how they affect business strategy.
- NFRD is very much about financial reporting. Environment, social aspects and human rights have an impact on finance in the longer term. This Directive is very much about long-term value creation - we call it non-financial reporting but in the end it is all about finance.
- We cannot think about this in a bubble. There are many other initiatives and work being done around this issue. We haven't invented our own European framework with the NFRD – we have adopted international frameworks. It is up to us to make sure that European companies are globally competitive.
- It is about reforming company reporting to include non-financial information; it is not about adding administrative burden. There are exemptions and safety valves for companies in the directive. FEE has come up with a discussion paper.
- The EC is preparing the guidelines. It needs to be principles rather than rules-based guidance. Stakeholders need to be encouraged to reply to the public consultation.
- Companies need to talk to their Member States about transposition. Only Denmark has done it so far and it went beyond the scope envisaged by the European Parliament and the Council.
- There is a potential for a financial statement to be separate from the management report. It is not quite integrated reporting, rather simultaneous reporting (based on the same financial period). Moving towards integrated reporting is the right step.
- The Shareholders' Rights Directive is going to put important new responsibilities on boards and it will be complementary to this Directive.
- Application of the NFRD will be about comparability – it is important to ensure that comparable information is going to be produced.

Jo Iwasaki, Head of Corporate Governance, ACCA

- While legislation may set out high level objectives, good practice will only evolve when people learn from each other what works and what doesn't, and put what they learn into practice.
- ACCA has been looking into the interaction between culture and corporate behaviour. Culture may not be measurable as such, but it manifests in variety of things: the way companies do business, how they promote and remunerate people and so on. These might be indirect measures: but taken collectively, they communicate a message

Paola Schwizer, Chair of Nedcommunity, ecoDa's board member; Chair of the Audit & Risk Committee of Credem S.p.A. and Inwit S.p.A.

- The board is expected to actively take part in defining long-term strategy. In times of crisis, it is not easy to deal with compliance issues; clever value creation requires an even bigger effort. At the same time boards will be deeply scrutinized by investors and other shareholders on the way it performs the new tasks.
- The letter Larry Fink, CEO BlackRock, addressed on February 2016 to the Fortune 500, states that "…it is the responsibility of the board to review, understand, discuss and challenge a company's strategy…. We are asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation…"
- The NFRD states that the Board will have to define, share and approve (and consequently "describe" in the management report): the group's business model; the policies (and their outcomes) related to environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters, diversity; the principal related risks (and their management strategies), considering any adverse impacts of policies and practices; non-financial key performance indicators relevant to the particular business.
- In practice, boards are good at approving documents prepared by management; less good at producing and shaping them.
- Despite the challenges, governance standards are all moving in the same direction – we see a call for boards to play a fundamental role for the long-term success of companies.
- If the board wants to lead the change, it has to change at first. Changes must take place in the way they are composed and in the way they work. We need to move towards active, diverse, business-driven and committed boards, with expertise in crises and turnaround, new and inter-market, digital and media, IT, cyber security.
- The first key success factor is board composition. Introducing innovation must then follow in the way boards work. It is important to focus on emerging opportunities, challenges and risks linked to new global trends, and to dedicate time for discussion and brainstorming without a strict agenda. Meeting with external experts can be beneficial.
- Boards should enforce open communication channels, and insist that data is synthesized into relevant and understandable information. .They should define goals and measure performances; develop effective processes, conduct induction and board evaluation and ensure proper succession planning.
- Some features of an advanced board member in terms of culture and behaviours are: change readiness; strategic mind-set; integrated thinking mind-set; leadership

experience; global mind-set; dialogue skills; openness; controllable ego and listening skills; collaboration, teamwork; trust, support and mutual respect; conflicts approached with transparency; informal relationships.

- Improvement is seen in the way the risks are considered in strategic terms. Most boards of directors start to understand that the risks are very closely linked to business even though it seems obvious. There is a lack of improvement on HR issues. Boards discuss HR very briefly and it should be changed.
- Standards and guidelines are helpful in increasing comparability and in explaining what is relevant in terms of information. We should avoid making out of non-financial reporting a pure marketing exercise.

Farid Aractingi, VP Audit, Risk and Organization Renault, Chairman Renault Consulting, Chairman IFACI, and Vice President ECIIA

- Presented the ECIIA/FERMA [3 Lines of Defence Model]
- Internal audit is a key actor because it is familiar with both governance and business processes. It can participate in the project team to provide guidance. Internal audit provides assurance on the compliance and effectiveness of the global Enterprise Risk Management system; assures accuracy and reliability of the information reported both internally and externally; and gives advice and insight about potential risks in the organisation.
- Internal auditors partner with external assurance providers, to ensure that the engagements are performed efficiently, reliably and cost-effectively.
- Therefore internal auditors are in a good position not only to help implement the non-financial reporting system, but also to ensure that it is not just a box-ticking exercise and provide a holistic and accurate view of the activities of the organisation.
- Internal auditors are independent – they have the capacity to say things bluntly but calmly. Their role aims at the progress of the company, and to this end, they are trusted partners not only of the board but also of the executive team and the operational managers.
- Internal auditors have a broad understanding of the business; they challenge disclosures regarding the organisation's values; and they assess risks, internal controls, and governance, related to the quality of the information published. So they can/must widely contribute to improving the process and data of non-financial reporting.
- It is important to stress that in order to preserve their independence, internal auditors do not take direct part either in the management of operations, or in the decision-making process, and report to the top management and the Audit Committee; the trust relationship between internal audit and audit committee is a key success factor to empower internal audit, and enrich the audit plan.
- In order to have a successful non-financial reporting practice, internal auditors will help develop the appropriate framework and define the KPIs to be included in the report. It is important to remember that there is no "one size fits all" solution regarding the NFR.
- The assurance given on non-financial reporting must cover adequacy, effectiveness and robustness of internal controls over NFR.

Noémi Robert, Senior Manager, Federation of European Accountants (FEE)

- The main success factors of an accurate, transparent and effective reporting are the need for consistency in application and the need for dealing with materiality. External assurance has also an important role to play.
- Disclosures are only required for matters critical to the undertakings, however, flexibility is needed. We should look for as much consistency as possible in disclosure and transposition across Europe. Reconciling flexibility and consistency is not always easy. The non-binding guidelines from the Commission could play a role in addressing this potential lack of consistency. An approach developing a common base level of KPIs could be used, and these KPIs would be the most relevant for the vast majority of undertakings that have to apply the NFRD; undertakings should still be allowed for additional disclosures of specific matters affecting their individual business.
- Internationally accepted frameworks are a very good basis for transposing and applying the NFRD. However, these existing frameworks don't really provide a complete answer to the requirement, mostly because of the application of materiality. More information in this recent FEE publication.
- Materiality is a key concept. The frameworks do not deal with it comprehensively; guidelines from the standard setters might be welcome. Internal auditors should play a key role in demonstrating which information is material to the specific undertaking and needs to be disclosed.
- The real potential of the non-financial information reporting is providing context for disclosures by integrating financial and non-financial information and by producing a holistic view of the business.
- Investors are asking for assured information because they want to be warranted that companies are not just showing the nice side of the picture. More information in this recent FEE publication. Statutory auditors are often in the picture when providing assurance. There is also potential for small firms to get involved in this.
- External auditors are not only focusing on numbers-based information anymore; firms are adapting their competencies and their recruitment in order to address non-financial matters.

David Szafran, Lawyer at Law Square and Chair of ISAR 30th session at UNCTAD

- Reminded that end of September 2015 at the United Nations, the head of states and governments have approved the 17 Sustainable Development Goals (SDG). This was also an occasion to perform a PwC survey that showed that 71 percent of businesses are already planning to engage with the SDG.
- At the UNCTAD, the intergovernmental working group on corporate reporting has developed an Accounting Development Tool (ADT).The ADT measures the level of implementation of internationally recognised standards, including on environmental and social issues.
- The mentioned SDG survey also showed that 78 percent of citizens are likely or very likely to use the goods and services from companies signed up to the SDGs – in many countries it's even higher.
- Before implementing new frameworks it is useful to identify the guidance that is already used on a voluntary basis. A PwC – LawSquare survey shows that 85 percent of the

largest Belgian listed companies already publish sustainable information on a voluntary basis; the majority already include that information in their management report. 40 percent of the companies refer to the UN Global Compact principles. 65 percent use the Global Reporting Initiative. 40 percent use external assurance on voluntary basis.

- The UN Global Compact principles include human rights, labour, environment and anticorruption & bribery. It is recommended to fully integrate this with an appropriate risk management and compliance program. In order to be able to disclose, it is important to have defined the policies and the KPIs. For instance, the UN provides guidance in the UN Guide for Anti-Corruption Risk Assessment.
- The board of directors is already the ultimate responsible for preparing the financial statements, including the annual report. The expectations towards directors, including members of the audit committee, are growing.
- As regards to the assurance of non-financial information, it is important to make the difference between publicity and reliable information that can be verified.
- Non-financial reporting, unlike the financial reporting, addresses larger variety of stakeholders. However, it should remain relevant to the stakeholders of the company issuing financial and non-financial information.

Carl Rosen, Vice chair of Better Finance and Head of State Ownership and innovation at the Swedish Ministry of Enterprise

- Many companies lost money over the past year due to the non-financial issues. The word non-financial is misleading because these issues are very much financial.
- We need better information for management and the board, as well as investors in order to understand the risks in the portfolios.
- A starting point for a business is as much freedom as possible – the less legislation the better. Investors are somewhere in between. Most of them want to be fully informed in order to make proper decisions but they don't want to pay so much for it. In the European context, it is very difficult to find a common framework for that. There will be some issues when it comes to the implementation of the NFRD.
- We are, however, moving in the right direction.
- Non-financial reporting has been a part of legislation in Sweden for some time and the outcome can only be described as positive.
- There has been a tremendous change in investors using non-financial information when making decisions. Few years ago very few companies looked at sustainability reports. Since then the situation has improved quite a lot. In ten years time it will be unacceptable not to consider these issues.

Concluding remarks

Henrik Stein, Group Audit Director DZ Bank, President ECIIA

- The new reporting requirements will increase the transparency of the business operations: but the way they are implemented will be key to avoiding extra burdens with no added value for the business. The governance model applied for the new reporting is very important: the information must be relevant, exhaustive and accurate.

- Regardless of the model developed, the board will have more work in order to assure that the non-financial reports are purposeful, reliable and credible. Internal audit can contribute to assuring the board and can partner with other assurance providers in order to give one language, one voice, and one view to the Board".
- We can also work together on corporate culture and ethics – aspects that have not yet received necessary attention, but which are essential both to business sustainability and to rebuilding shareholder and stakeholder trust in businesses across Europe and further afield.

ABOUT THE ORGANISERS:

ecoDa: European Confederation of Directors' Associations http://www.ecoda.org/
ECIIA: European Confederation of Institutes of Internal Auditing http://www.eciia.eu/
ACCA: The Association of Chartered Certified Accountants http://www.accaglobal.com/gb/en.html