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Brief

How the European Directive 2014/95/EU shaped the non-financial reports of Italian listed companies: environmental features and political implications

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Abstract

FEEM Policy Brief

In December 2016, the European Directive 2014/95/EU (namely Directive) has been adopted by the Italian legislative system with the Legislative Decree n. 254/2016, which sets the legal framework for regulating the non-financial information disclosure of companies. The purpose of this policy brief, which represents a part of a wider research project[1], is to understand how Italian companies have interpreted the Directive with their non-financial report (NFR).

[1] The data gathering and the econometric analysis has been led by a team of master students (Claudia Pezzana, Giulia Dario, Silvia Antonina Randazzo, Andrea Sereno) and researchers of University of Turin, please to contact the authors for further information;

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01 Introduction

According to the Directive, organizations called to mandatorily disclose non-financial information are:

- large undertakings[2], as defined by Directive 2013/34/EU, or
- public-interest entities, or
- organizations with an average number of employees exceeding 500 during the financial year.

The Directive defines as non-financial information (NFI) those "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 brief description of the company's business model, a description of the policies adopted regarding the listed issues, the outcome of those policies, the principal risks related to those matters linked to the company's operations, and non-financial key performance indicators relevant to the particular business" (European Parliament, Directive 2014/95/EU).

Two main principles are introduced by the Directive:

1) The "*materiality*" principle, which 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".
2) The "*comply or explain*" principle, under which a company may avoid disclosing certain types of sensitive information; however, if information is omitted, companies must fully explain underlying reasons.

The Directive is considered as a breakthrough moment in the sustainability reporting literature as it encourages companies to engage in non-financial reporting activities and provides the basic requirement to report using a stand-alone document or other forms of reporting. To help companies in this activity, the Directive suggests to follow international sustainability reporting guidelines, also with the aim of enhancing "the consistency and comparability of non-financial information disclosed". With

[2] Defined as exceeding 2 out of 3 of the following criteria for 2 successive accounting periods:
- a balance sheet total of EUR 20 million, or
- a net turnover of EUR 40 million, or
- average number of employees of 250.

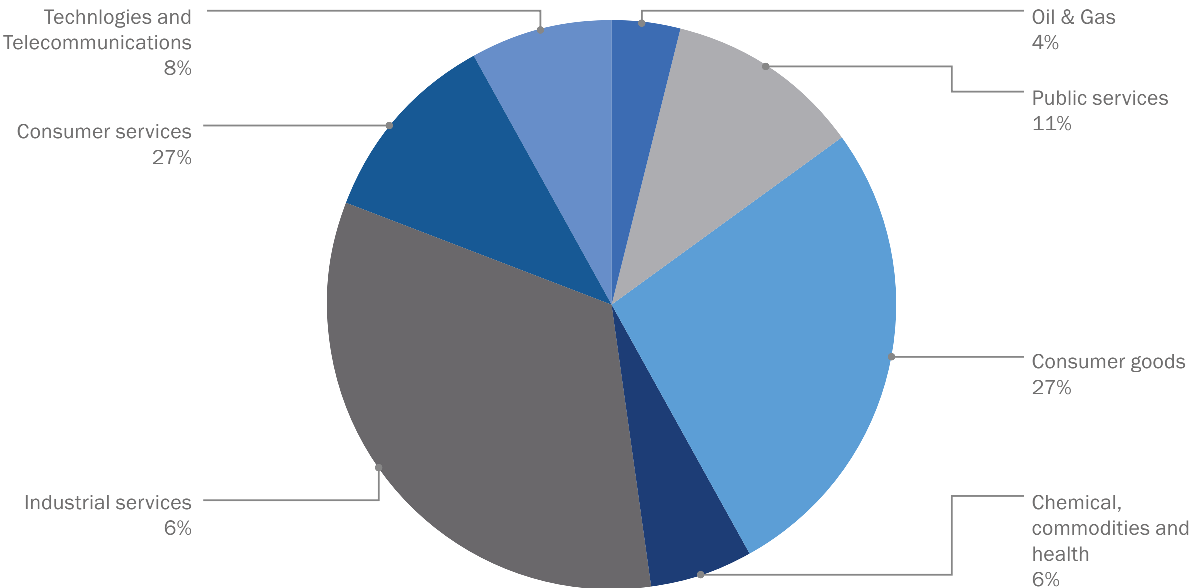
this Directive, the European Commission transform the sustainability reporting activity from a voluntary activity to a mandatory one.

To let the Directive effective, Member States have translated it into their legislative system, and this has been due to the high diversity and fragmentation ruling in each state. In Italy, the Legislative Decree n. 254/2016 has introduced modifications and additions to the Directive. Specifically, the detail required to report information depends by the type of legal entity, a mechanism for imposing sanctions on non-compliant entities (a form of assurance) has been introduced, and finally, the possibility to report non-financial information even for entities not included by the decree.
The empirical research

02 The empirical research

The study focused on the non-financial information disclosed through the mandatory reports published by the Italian listed companies in 2018: the sample has been composed by 122 companies, banks, insurance and financial services excluded. The reports analysed were those of 2018, the second year of introduction of the Directive. The composition of the sampled companies by business sector has been as follows: Consumer goods (27%), Chemical, commodities and health (6%), Oil and gas (4%), Consumer services (11%), Industrial services (33%), Public services (11%), Technologies and Telecommunications (8%).

Figure 1. The sample divided by business sector



A content analysis that is an established method used to study disclosure quality, has been implemented in its quantitative form (Milne and Adler, 1999; Vourvachis and Woodward, 2015). Researchers has performed manually checked the content of each report, without the use of particular software, because interpreting non-financial information disclosed for the first time has been critical. Suddenly, each information was collected and included in a database. Initial considerations can be drawn, such as: 76% of the companies decided to use a stand-alone report, while the remaining 24% included non-financial information as a section of the traditional financial report. All the reports have been assured, as a mandatory requirement of the Italian transposition of the Directive. The average length of the documents analysed is about 97 pages with values ranging from a minimum of 15 to a maximum of 374 pages, showing a great discrepancy.

Although the Directive and its Italian implementation do not mandatorily suggest any specific reporting framework, the vast majority of reporters equal to 96% has adopted the GRI standard[3]; specifically, 70% of them have used the Core option[4], 5% Comprehensive option[5] and 18% simply refer to the GRI. With the aim of identifying material topics, GRI standard suggests writing a materiality matrix which helps organizations to identify and combine which are the main significant topics (economic, environmental, and social impacts) for both organization and its stakeholders, reported by 78% of the companies considered.

Other frameworks and initiatives are referenced like:

- The Sustainable Development Goals of the United Nations and developed in order to reach a new global sustainable development agenda are mentioned by the 40% of the reporters.
- The United Nations Global Compact which is aimed at encouraging companies to adopt increasingly sustainable policies and in compliance with CSR is referenced by the 25% of the reporters.
- The Carbon Disclosure Project (24% of reports included it) offers a measurement system to collect, manage and share

[3] The GRI Standards is an organization established with the aim of providing support to both the public and the private sector in understanding, measuring and communicating the impact that an activity can have on different dimensions of sustainability, economic, environmental and social.

[4] This option indicates that a report contains the minimum information needed to understand the nature of the organization, its material topics and related impacts, and how these are managed.

[5] This builds on the Core option by requiring additional disclosures on the organization's strategy, ethics and integrity, and governance. In addition, the organization is required to report more extensively on its impacts by reporting all the topic-specific disclosures for each material topic covered by the GRI Standards.

information relating to climate change.
- Very few companies, only the 6%, have adopted the suggestions of the Task Force on Climate-related Financial Disclosures, even if is emerged that almost half of these companies acknowledge the financial risk of climate change in their annual reports.
- Few reports have been written according to the International Integrated Reporting Council (5,7%) which is a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs which promotes communication about value creation identifying specific capitals.

Vast parts of the reports are dedicated to the disclosure of risks. The disclosure of how Enterprise Risk Management models work, is reported by 61.5% of organizations, where the risk management system that allows the identification of companies individual financial risks is presented. Among such risks, we can found also climate-related risks. Of great importance is the disclosure of risks regarding the supply chain: 65.5% of companies declare that they evaluate their suppliers with an audit (in most of the case very simplistic), 61.5% with a self-certification and 40% in accordance with an international standard. Regarding how organizations manage sustainability issues, 41% of the firms have established a sustainability committee, which has the task of discussing, defining, implementing and supervising the strategic corporate activities relating to sustainable development and corporate social responsibility. In the rest of the cases, the various functions related to sustainability have been divided among the other committees already present within the companies.

Regarding the most common environmental indicators, the study has specifically analysed the reporting of:

1) Greenhouse gas emissions (GHG), which represents the total annual amount of GHG emission for the company. This indicator has been analysed distinguish primarily Scope 1[6] and Scope 2. Scope 3 emissions have been reported only by a small part of the companies (26%).
2) Water consumption, which is a variable that represents the total annual quantity of water resources used by companies.
3) Waste production, which is a variable that represents the total annual amount of waste produced by companies.

Despite these three indicators are well-known as a credible measure for an initial assessment

[6] The GHG Protocol Corporate Standard classifies a company's GHG emissions into three 'scopes':
- Scope 1 emissions are direct emissions from owned or controlled sources.
- Scope 2 emissions are indirect emissions from the generation of purchased energy.
- Scope 3 emissions are all indirect emissions (not included in scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions.

of the environmental performance of a company, not all the reports included all they three. For instance, applying the materiality principles, topics like waste production and water, can be pulled out from the report content. Considering the sample, 24% (29 companies) did not report data relating to water consumption, 15% (19 companies) related to waste production, while less than 5% (6 companies) did not report data related to greenhouse gas emissions.

Regarding the adoption of social and environmental management system, the most common environmental management system certification is UNI EN ISO 14001:2015, adopted by 67% of the sample. Other certifications, like UNI EN ISO 14025:2010 concerning the Environmental Product Declaration, has been adopted only by 3 companies, and ISO 14064, concerning the assessment, management and certification of organizations' greenhouse gases, implemented by 7% of the sample. The instrument used for assessing environmental impacts associated with all the stages of the life-cycle of a commercial product, process, or service, the LCA, was adopted only by 21 companies (17%); moreover, the environmental footprint indicators, that calculate human impact on the environment, have been used by very few companies.
As emerged by this overview, it appears clear that the sampled organisations behave differently. Some trends such as the adoption of a risk management systems or the management of risks along the supply chain are commonly identified as critical factors, while others, such as water management or waste management are still under considered. Far from being truly comparable, having access to such information can help regulators understanding who is deeply committed towards sustainability concerns and what can be improved. In addition, critiques about the width and span of the Directive and its effectiveness are increasing, especially after the first years of adoption.

Critical issues

In order to understand in a more comprehensive way the findings, it's important to highlight some aspects:
First, the shortcoming emerges from the NFRs, are not due to the Directive itself but rather to the type of legal act which European Union chose to regulate this subject, the Directive: this is a legislative act that sets out a goal that all EU countries must achieve, however, it is up to the individual EU countries to devise their own laws on how to reach these goals. This decision will lead each EU country to have its own rules to follow in order to write the NFRs. And secondly, as a consequence of this

decision, each EU country is responsible for devising their own rules and looking at the Italian case, it seems that Italian legislator has been vague in several points and that a complete checklist has not been provided, thus ultimately making the Italian companies themselves responsible for choosing the non-financial information to be included in the NFRs; as a result of this, in fact, the reports are far from being truly comparable.

04 Recent policy developments

Revising the Directive has become a reality. In March 2018, with the Action Plan On Financing Sustainable Growth, the European Commission planned a revision of the non-binding guidelines (NBGs) of the Non-Financial Reporting Directive (NFRD), issued on June 2019. In another Communication of the December, 11, 2019, presenting the European Green Deal, the revision of the Directive has been established for 20 February 2020 - 11 June 2020 as part of the European strategy to strengthen the foundations for sustainable investment. The adoption of the changes is planned to be presented to the public during the fourth quart of 2020.

In support of the European Commission, the assistance of the Climate Disclosure Standard Board was requested, which took action through the publication of a proposed amendment containing the changes necessary for the Directive to take on greater relevance and concreteness; also other international organizations like Carbon Disclosure Project (CDP) and the Task Force on Climate-related Financial Disclosures (TCFD) are currently involved publishing documents aimed at strengthening the implementation of the updated Directive.

Conclusion

The aim of this policy brief to understand how Italian companies are responding to the new Directive related with the disclosure of non-financial information. The mixed results of this first analysis are due not only to the high flexibility characterizing the Directive, but also to the use of incomplete, heterogeneous and inaccurate indicators, which lead to a high degree of non-homogeneity between the non-financial statements of the companies, leading to reports that are difficult to compare with each other. An update of the Directive and flowed by its national transposition will lead the companies to have a clearer and more determined and detailed scheme to follow. This first Italian results confirm a highly not homogenous reporting landscape and as such, regulators should consider how companies translate the Directive and the national regulations in practice, its barriers and limitations.

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