

European Lab consultation on future projects

1. Section 1: Introduction

Objective of the European Lab future projects agenda consultation

The European Corporate Reporting Lab @EFRAG (European Lab) was established by EFRAG, following a call by the European Commission in its March 2018 Action Plan on Financing Sustainable Growth. The European Lab serves the European public interest and its objective is to stimulate innovation in the field of corporate reporting in Europe by identifying and sharing good reporting practices through:

- (a) Facilitating dialogue between reporting companies, users and other relevant stakeholders and organisations; and
- (b) Documenting the content and outcomes of this dialogue in reports and other means, for making them available in the public domain.

Corporate reporting issues are part of a wider debate of communication to the markets and other stakeholders of sustainability and corporate social responsibility information, and that there is an interplay with various external factors, initiatives and discussions. The European Lab supports and contributes to the implementation of the EC Action Plan in areas within its competence.

More information on the governance and operation of the European Lab can be found on the [EFRAG website](#).

The first project of the European Lab, currently in progress, is on climate-related reporting. The project is assessing the current state of play for climate-related reporting by European companies, and the current and potential use of climate-related information by investors and other users. The primary focus is on the Task Force on Climate-related Financial Disclosures (TCFD) recommendations with consideration of other reporting frameworks as appropriate, while also taking account of the European Commission's non-binding Guidelines on non-financial reporting issued in July 2017 and their supplement Guidelines on reporting climate-related information issued in June 2019. Focus areas are climate-related disclosures and scenario analysis.

The decision to add a project to the European Lab agenda is made by the European Lab Steering Group, taking into consideration input from stakeholders in a public consultation.

This public consultation seeks views on European Lab future project topics and their prioritisation. We also seek your input on any possible alternative project that in your view would be more important and urgent for the European Lab to undertake than the three projects proposed in the public consultation. We welcome views on any of the points addressed by 30 September 2019.

Input required from stakeholders

In the next section (Section 2), the European Lab outlines three potential topics identified by the European Lab Steering Group to be considered as future projects of the European Lab.

The questions to stakeholders are found in Section 3.

Replies should be submitted by 30 September 2019.

All replies received will be placed on public record, unless confidentiality is requested.

For any queries contact europeanlab@efrag.org.

Proposed topics for future projects of the European Lab

The European Lab Steering Group has identified three possible future project topics:

- (a) Reporting of social matters and human rights.
- (b) Reporting of non-financial risks and opportunities, and linkage to the business model.
- (c) Reporting on the materiality assessment process and outcomes for Environment, Social and Governance (ESG) matters.

The next section (Section 2) presents a brief description for each of the proposed topics.

2. Section 2: Description of proposed topics

Project 1 – Reporting of social matters and human rights

The Directive 2014/95/EU on non-financial information reporting (NFRD) requires large European companies to report, amongst other things, on social matters and human rights. This area also forms an integral part of the United Nations Sustainable Development Goals (SDGs) which are increasingly integrated into companies' business strategies. Social and human rights play an important role in strategies relevant to SDGs, and regulations on corporate responsibility towards respecting social engagement and human rights is increasingly being enacted. However, with attention concentrating mainly on the environment including climate change and due to difficulties in quantification of social matters, the reporting of relevant information and its linkage to business models and long-term value creation is generally limited or even missing from corporate reports. The need for improved reporting on social matters and human rights was highlighted in a 2018 Alliance for Corporate Transparency report and through the European Securities Market Authority (ESMA) 2018 report on enforcement priorities.

At the same time, there is no commonly accepted definition or consensus on what topics fall under “social matters”. For example, a 2018 World Bank report on incorporating ESG factors into investments highlights that different organisations have different topics under their definition of “social matters”. Hence, a project that focuses on “social matters” may be too broad if it was to address all potential topics and there is need to focus on specific topics. For this reason, a European Lab project on this topic would aim at identifying good reporting practices on the use of relevant metrics and other disclosure of social matters and human rights in one of the specific focus areas to be selected as outlined below.

Need for a focus on sectors that have higher impact on human rights: Human rights is a cross-cutting issue across the specific focus areas considered below. Hence, as part of the analysis of good reporting practices, it will likely be necessary to focus on the sectors that have higher impact on human rights.

Focus area 1 – Reporting on social matters and human rights in the supply chain

Supply chains can be a significant driver for companies success, through value creation and innovation.

The complexity added to supply chains by the involvement of multiple countries, tiers, structures and interdependencies has a critical impact on business operations, reputations and investment performance.

As supply chains often fall outside of companies core operations and control, they may expose them to significant risks typically driven by ESG factors, such as human rights abuses, corruption, social issues within the work force and labour standards, fair operating and trade practices by and with suppliers, natural resources depletion, community engagement and development.

Public awareness of supply chain issues continues to grow, and companies are increasingly under scrutiny in respect of their action on major human right issues among their suppliers.

This focus area would primarily be on reporting human rights associated with supply chains. However other 'social' matters, as enumerated in paragraph 17 above, could also be considered.

Furthermore, companies are increasingly expected to understand and prevent or mitigate human rights risks that may occur in their supply chain as well as to manage their exposure to such risks. In support of meeting their responsibility to respect human rights and their reputation, and to ensure the resilience and sustainability of their business model, companies are called to include in their corporate reports information on indirect (third party suppliers) or internal (supply chain management) related risks and opportunities), together with their associated due diligence processes, and provide evidence on the effective management of these risks.

Focus area 2 – Reporting on human capital management

Human capital has been defined by a number of organisations as the knowledge, skills and attributes of the workforce and others across the value chain. Human capital management forms a significant part of business processes for enhancing business performance and value creation. Companies are therefore expected to include information on human capital management in their corporate reports in relation to the resilience and sustainability of their business model. Hence, this focus area would primarily be on good practices in the reporting of human capital management.

In addition to reporting on human capital management, and to the extent that the scope does not become too broad, this focus area may be extended to the way that companies report on how they manage issues related to social capital. Social capital often being defined as the value added to society by companies' products, services and activities, as well as the relationships within and between communities, groups of stakeholders and other networks. Depending on particular business models, different factors impact on social capital including but not limited to: community relations; customer data security; transparent information, fair advice and pricing; and measures to ensure product safety. Hence, this focus area could include examples of reporting on factors that impact on social capital.

Focus area 3 – Reporting on human capital and social capital impacts of climate adaptation and mitigation policies

Climate change impacts are systematic in nature. As such, climate adaptation and mitigation measures are prevalent across a variety of sectors. These measures can not only have internal impacts within companies but can also have broader impacts at a societal level. As highlighted in the recently published EC Guidelines on reporting climate-related information, many companies are dependent on human capital, such as the skills and motivation of employees for the purposes of climate adaptation and mitigation. For example, employees can be critical to the development of innovative low-carbon products and services or jobs can be eliminated due to new processes and technologies. In this respect, human capital management can be interrelated with companies' climate adaptation and mitigation measures.

Furthermore, as noted in the EC guidelines, climate mitigation and adaptation can also impact on companies' social capital including on the level of trust companies' enjoy amongst external stakeholders. Under the UN Guiding Principles on Business and Human Rights, companies are expected to address the human rights implications of climate change.

One example of how climate adaptation and mitigation policies are considered in relation to social matters and human rights is the extent to which Metals & Mining and Oil & Gas exploration and production companies with climate risk exposure consider the security and land rights of indigenous peoples in their operations and measures taken to mitigate climate risk. For example, whether an Oil & Gas company that is changing its energy mix towards renewable sources, does so while managing adverse social impacts that would arise if the human rights of affected parties were ignored. There are other examples of impacts on social capital that occur depending on particular business models, location of companies' operations and climate risk mitigation strategies. Hence, this focus area would be on good practices around how companies integrate information about impacts on human capital and social capital in the reporting of their climate-related adaptation and mitigation strategies.

Project 2 – Reporting of non-financial risks and opportunities, and linkage to the business model

Stakeholders need to better understand the business model of companies and the impact of non-financial considerations on their strategy and activities. The NFRD requires reporting on the business model, policies pursued by the group, outcomes of those policies, principal risks linked to the group's operations and non-financial Key Performance Indicators (KPIs). Apart from the NFRD requirements, reporting on the nature, position, performance and development of the business, together with the principal risks are included in Directive 2013/34/EU (the Accounting Directive) and through the International Accounting Standards Board (IASB) Management Commentary Practice Statement which provides voluntary guidance for IFRS reporting companies. Notwithstanding the multiple sources of guidance, a number of reviews of both EU and global companies' reporting practices have shown that there is scope for improvement in the linkage between the business model description and non-financial information including the related risks and opportunities.

For instance, a 2018 Climate Disclosure Standards Board (CDSB) report based on a review of 80 EU companies found that frequent failures in linking non-financial information such as climate risk with the business model description. Another study^[1] that reviewed the disclosures of 15 Oil & Gas companies found that many of these companies disclosed greenhouse gas emissions in terms of performance and future goals, but explanations of discussions about how targets related to the business model and strategy were rare. Similarly, a 2018 Alliance for Corporate Transparency report assessed the extent to which companies disclose their business strategies and products or services for pursuing opportunities connected with a sustainable economy. Based on the analysis of reporting by a sample of 105 companies, the report highlights that there is room for improvement enhancement in the information provided on strategies relating to social and environmental areas including information on related KPIs, targets, revenue and investments.

A robust description of the business model that conveys the sources of competitive advantage, risks, opportunities and the sustainability of the business model over time is a core input of users' assessment of companies' competitive position in comparison to peers. Furthermore, in the absence of a robust business model description, users can have difficulty in identifying the link between the business model and changes over time in companies' reported risk tolerance and principal risks including non-financial risks.

This project would focus on examples of companies' business model reporting and linkage to non-financial risks and related opportunities. Whereas non-financial risks that arise from the external operating environment could negatively affect the prospects, performance and risk exposure of companies, there can also be opportunities for enhancing profitability for companies that adapt their business models in response to the non-financial risks. For example, a company could improve profitability through the launch of new, high-demand products certified to environmental and/or social standards or through energy-efficiency driven cost savings or through steps that impact on companies' sustainability reputation and social license to operate. The project could consider the reporting of economic impacts of risks and opportunities and the positive or negative social or environmental impacts of companies' related strategies.

Project 3 – Reporting on the materiality assessment process and outcomes for Environment, Social and Governance (ESG) matters

Materiality is one of the fundamental principles of the non-financial reporting introduced by the NFRD. However, despite its relationship to the principle of materiality for financial reporting, it is widely considered to be more challenging because of (i) the higher level of subjectivity stemming from the typically less prescriptive nature of non-financial reporting requirements, (ii) the longer time-horizon, and (iii) the consideration of the information needs of, and the effects on, a wider range of stakeholders.

Complexity is also increased by the existence of multiple definitions and frameworks, and many organisations find it challenging to navigate the range of materiality definitions across reporting regulations, standards and frameworks. The project would provide insights for both users and preparers by identifying good practices in relation to reporting on companies' materiality assessment processes and outcomes in relation to Environmental, Social and Governance information. The reporting of the materiality assessment can be an input to users' assessment of the relevance of any disclosed ESG KPIs and targets, and to their understanding of which of the ESG factors have the greatest impact on a company's risks and opportunities.

The project would consider the dual perspective of materiality in relation to ESG information. That is, the project would consider the material impacts a company has on the environment and society, as well as material impacts the environment and society have on the organisation, including, but not limited to, the following:

- (a) Reporting about the materiality assessment process including the links with the organisation's strategy, governance, policies and risk management;
- (b) Reporting about the level of engagement with providers of financial capital and other stakeholders; and
- (c) Reporting about the outcomes of the materiality assessment process.

In carrying out this project, the European Lab would consider existing frameworks and definitions of materiality but would keep a 'neutral' approach by not giving precedence or prominence to any specific framework.

It should also be noted that, as in all the projects of the European Lab, because the frameworks regarding materiality for non-financial information are either recently applied by companies or are evolving, what is considered to be good reporting practices today is likely to evolve once companies get to a more mature stage of implementation.

3. Section 3: Questions to stakeholders

General information about the respondent

Please provide the following details:

(a) **Your name:**

Lorenzo Simoni

(b) **Your contact e-mail address:**

lorenzo.simoni@unifi.it

(c) **Your job title/role:**

Research fellow

(d) **Name of the organisation on behalf of which you are responding:**

University of Florence

(e) **Country of operation:**

Italy

(f) Which type of respondent are you representing?

Academic

Please specify:

(g) Short description of activity/industry:

I am a research fellow in accounting. I have taken part in several research projects about business model reporting, intellectual capital, non-financial indicators, CSR, and default prediction.

(h) If you are responding on behalf of a reporting company, are you directly involved in the preparation of corporate reports?

Not applicable

Information required on proposed projects

(i) Please rank the proposed project topics outlined in the previous section (Section 2) by order of priority, and explain your selection with details of the distinct added value you would expect of a potential European Lab project on each topic:

	Priority			Reasoning for your selection and scoring
	3	2	1	
Project 1.1 – Reporting on human rights and other social matters in the supply chain	X			Reporting on human rights and social matters has become a crucial issue in recent years. Stakeholders are demanding information about human rights and other social matters. Despite the disclosure on human rights and social issues has become mandatory, the absence of a clear definition of social matters and of an effective framework for disclosure spurs further investigation of how companies might report on this issues in order to satisfy stakeholder. Moreover, some academic strands of research claim that to be effective, disclosures on social and environmental issues need to integrate the views of a the main stakeholder groups. Hence, building a dialogue with stakeholders is essential to understand which the critical issues are and what should be reported. Much effort is needed to advance our knowledge about effective reporting on human rights and social matters and the extent to which companies' disclosures actually provide information on the needs of different stakeholder groups.
Project 1.2 – Reporting on human capital management		X		Despite being a key issue in non-financial reporting, human capital has already been the object of many academic studies on intellectual capital. These pieces of research have investigated differences in human capital reporting practices, the main factors that drive these differences, and the consequences of human capital disclosures on investment decisions. Some critical pieces of research also document a failure of intellectual capital statements (including human capital disclosures) to add value to investors. I think that future studies in this area should address the interaction between human capital disclosures and other kinds of non-financial information, like business model, non-financial indicators and risks. In particular, as the business model indicates how a company generates value and which key resources of an organization are, it becomes essential to understand the role of human reosurces in value creation and a key for human capital disclosure, as well as for the communication of other intellectual capital elements.
Project 1.3 – Reporting on human capital and social capital impacts of climate adaptation and mitigation policies		X		Some considerations on human capital disclosures made at the previous point can be extended to this point. Moreover, I see some potential overlaps and redundancies with the current project on climate reporting.
				Recent non-financial regulations require companies to provide information on their risks

<p>Project 2 – Reporting of non-financial risks and opportunities, and linkage to the business model</p>	<p>X</p>		<p>Recent non-financial regulations require companies to provide information on their risks. However, companies have high discretion in disclosing information about risks. Despite risk reporting is mandatory, the absence of strict requirements make this kind of disclosure voluntary in nature. Academic literature has shown that the generic requirements often lead companies to include only generic risk statements, which do not offer specific information about threats to a company's capability to create value. In this context, external users need a tool to understand whether and to what extent risk reporting is able to shed light on the opportunities and threats that affect the key competitive success factors. As the business model illustrates how a company combines its key resources, know-how and activities to create value, this concept offers a platform for risk reporting. Non-financial regulations recommend to offer an integrated communication, where the business model acts as a framework for non-financial disclosure, including risks. A project in this field may help assess whether and how companies effectively integrate business model and risk reporting. The project could contribute to the formulation of guidelines and recommendations to offer a more integrated disclosure.</p>
<p>Project 3 – Reporting on the materiality assessment process and outcomes for Environment, Social and Governance (ESG) matters</p>	<p>X</p>		<p>The concept of materiality is a key issue in non-financial reporting. In fact, non-financial information should allow users to assess its impact, intended as impact that a company's activities has on society at large. This poses new challenges related to the definition of materiality of non-financial information and of the assessment of materiality. A project in this field should aim to understand how the concept of materiality has evolved and how it impacts decisions. The project could involve managers of large companies, as well as different stakeholders group, in order to assess current materiality assessment practices and possible ways to improve them. As emphasized by the GRI, the involvement of stakeholders is crucial to assess materiality.</p>

(j) Are there other topics that you advise the European Lab to add to its agenda? If so, please provide a description of the topic and the priority you would assign to it:

Non-financial key performance indicators (NFKPIs) might offer valuable information about a company's value generation, acting as complement to financial information. While narrative disclosures depict the context of a company's operations and their impact, NFKPIs can be used to assess the credibility of narratives and enhance the comparability of non-financial information. Despite the importance of NFKPIs, some studies show that companies rarely disclose them in the management commentary, even when they are required. In many cases, NFKPIs disclosed are generic indicators, which do not shed light on the real drivers of value - i.e. the elements that characterize a company's business model. Hence, the issue of how to improve NFKPI disclosure and how to link NFKPIs to value creation could be considered. Moreover, non-financial regulations require companies to disclose the same set of NFKPIs from one year to year. If the set of NFKPIs changes, detailed explanations for this change should be provided. However, empirical studies on compliance with NFKPI presentation requirements and their perceived benefits are scarce.

(k) Please provide any details of interaction you may be aware of with the work of other initiatives, in respect of the topic you rank as highest priority:

Some of the proposed topics are investigated and covered by different entities. GRI has dealt with the concept of materiality of non-financial information. Regarding information about human rights and social matters, many companies have started reporting on the Sustainable Development Goals developed by the United Nations. Finally, entities like the International Integrated Reporting Council (IIRC) and the World Intellectual Capital Initiative (WICI) have proposed frameworks to offer an integrated communication of financial and non-financial information, with the aim to report on intangibles, sustainability issues, non-financial risks. Both IIRC and WICI recognize the importance of business model as a framework to disclose and link different kinds of information. Personally, I have investigated business model disclosure in the annual report. Together with other colleagues from the University of Florence, I have developed a research project on the use of business model as a framework to disclose non-financial indicators. The project has been funded by the Institute of Chartered Accountants of Scotland (ICAS). Other projects I have taken part in examine the consequences of business model disclosure on investors and preparers and users perceptions of business model and non-financial indicator disclosures. These project have been deveoped in collaboration with colleagues from the University of Florence (Italy), Aalborg Univeristy (Denmark) and Aarhus University (Denmark). I am currently developing a work on the link between risk reporting and business model reporting. My colleagues and I are conducting and empirical research to assess whether companies' risks disclosures reflect the elements that companies report as constitutive elements of the business model.

4. Thank You!

Thank you for taking our survey. Your response is very important to us.