

8 June 2020

Directorate-General for
Financial Stability
Financial Services and
Capital Markets Union
European Commission
B-1049 Brussels

submitted via email to:

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Re.: Consultation Document: “Review of the Non-Financial Reporting Directive”

Dear Sir/ Madam

The Institut der Wirtschaftsprüfer in Deutschland e.V. [Institute of Public Auditors in Germany, Incorporated Association] (IDW) appreciates the opportunity to provide its views concerning a possible revision of the Non-Financial Reporting Directive (NFRD) in response to the European Commission’s Consultation Document: “Review of the Non-Financial Reporting Directive”.

The IDW represents over 11,000 Wirtschaftsprüfer [German Public Auditors], which is approximately 85 % of all Wirtschaftsprüfer in Germany. Our members are from the only profession in Germany to have been entrusted with the performance of statutory audits of the financial statements of the larger publicly listed companies that are presently required to publish non-financial information (NFI).

In the prevailing German legal environment, the financial statement audit also involves the performance of (reasonable) assurance procedures in respect of information presented in the management report. NFI reporting has, however, to date, been specifically excluded, as only an “existence check” by the statutory auditor was prescribed in transposing the NFRD into German law. This notwithstanding, there has been a growing trend since then for entities to voluntarily seek external assurance (usually from their financial statement auditor) in respect of the NFI they are required to report.

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Daniela Kelm, RA LL.M.;
Melanie Sack, WP StB

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We are writing this letter to accompany our response to the afore-mentioned consultation questionnaire, which we have also submitted online. Due to the nature of a questionnaire, it is difficult to provide information on our views and proposals in a coherent manner, so we have taken the liberty of writing this accompanying letter.

We firstly make a few general remarks and then comment on specific aspects of a possible revision of the NFRD.

General Remarks:

Sustainability goals must remain on track

In our view, the leading role adopted by the European Commission in the debate on sustainability, including climate protection is highly commendable. The European Commission's intention to consider a review is timely, as recent developments firmly underline the urgency with which sustainability in terms of climate – but also in its wider sense – must be addressed.

We firmly believe that a concerted shift to truly sustainable thinking by businesses and private individuals alike, culminating in appropriate and sustainable action, will be key to positive development and growth within individual Member States, in Europe and throughout the world.

The current coronavirus pandemic is continuing to have a significant and, in cases devastating, impact on all parts of the world. It is essential that rebuilding initiatives that will come in its wake place sustainable thinking at their very core.

Reliable sustainability-related information is essential

We are convinced that the EU Commission's various goals in the context of sustainability, including sustainable finance and climate control can only be achieved when all relevant stakeholders have confidence in the information entities report publicly on ESG matters and other relevant non-financial information.

Creation of trust in information is a core service our profession currently provides. German public auditors are required to form opinions on both an entity's financial statements and management report and to report thereon in their published auditor's report as well as the more detailed long-form audit report presented to the entity's internal supervisory board.

Specific Remarks concerning the possible revision of the NFRD:

The future of sustainability reporting

Extension of the scope of the NFRD

Non-financial information is becoming increasingly important for many corporate stakeholders. This is particularly true with respect to large entities, but increasingly also for the medium-sized and smaller entities, which generally constitute a large proportion of the economy.

In order to meet the growing demand for non-financial information, we generally support a moderate but gradual expansion of the scope of entities subject to reporting requirements, coupled with a period of grace to allow all entities newly affected sufficient time to develop the suitably effective measures and systems they need to capture the required non-financial information.

We would like to point out that many SMEs are affected by NFI reporting anyway, as they often form part of a supply chain and thus already have to generate relevant information. This notwithstanding, we recommend the position of SMEs be considered carefully, as we are aware that the requirements of the NFRD posed major challenges even for well-positioned capital market-oriented groups. The development of effective measures and systems of reporting systems is often associated with high costs. In any case a 1:1 transfer of the current requirements applicable to large listed entities to SMEs would be inappropriate.

Instead, in developing a reporting standard for NFI, we suggest a building block approach be taken. As a first step SMEs and their most important stakeholders should be involved in determining how selected, essential sustainability information could be adequately and appropriately included as a basis for the development of a common NFI standard.

Support of the TCFD recommendations

The IDW advocates (at least temporarily) an appropriate adoption of the recommendations of the TCFD at EU level, and has recently expressed its support, specifically, as a co-signatory to the call for action "Acting in Response to Climate Change" of the *Accounting for Sustainability Project (A4S) Accounting Bodies Network*, initiated by HRH The Prince of Wales.

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However, the long-term objective should be to achieve full integration (connectivity) of financial and non-financial aspects in a comprehensive corporate monetary reporting framework. The IDW therefore supports various initiatives; for example, we are closely following developments including the *Value Balancing Alliance* (see also our comments below).

Appropriate design of an extension of the reporting obligation of forward-looking information required

We are aware that there is a desire in some quarters for as far-reaching future-oriented information as possible, which is understandable. The limitations of the informative value of medium and long-term forecasts have been discussed extensively for a long time, and are rooted in the inherent uncertainty surrounding future developments – as the Corona crisis has once again demonstrated (see also the separate section at the end). The disclosure of long-term forecasts for non-financial indicators (as is also the case for financial indicators) or key figures is therefore impractical for the reporting entities concerned, nor would it provide reliable added value for those seeking to use such information. Indeed, there is a danger that such information might suggest a degree of apparent accuracy that is not deliverable, which would even impair confidence in corporate reporting. In our opinion, an undifferentiated demand for far-reaching quantitative forecasts is therefore inappropriate. Instead, a qualitative reporting on corporate planning and, if necessary, also the explanation of target figures for key non-financial indicators or ratios on the basis of suitable scenarios would appear to be more appropriate.

Further standardisation of non-financial reporting

There is no question that a consistent application of internationally standardised (and thus comparable) financial reporting standards enhances the efficiency of international markets. For this reason, the EU has also established IFRS as the (financial) reporting standard for capital market-oriented companies within the European Union. Since stakeholders generally have comparable information needs with regard to non-financial aspects, relying on an international reporting standard with broad acceptance appears to be an obvious choice for NFI, too.

However, there is no such standard available at present, as none of the existing initiatives currently display the necessary precision or holistic approach. Furthermore, currently no body currently enjoys the desired and necessary

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broad global acceptance. The IDW supports the position recently discussed in the Cogito paper "Interconnected Standard Setting For Corporate Reporting" developed in conjunction with Accountancy Europe (AcE). In this context, we would also like to draw attention to the Statement made by Teresa Ko on May 14th, 2020, in which she outlines possible future roles the IFRS Foundation could play in supporting progress towards the development of high-quality, internationally recognised standards for sustainability reporting.

This notwithstanding, the IDW also considers the development of a European solution to be a feasible intermediate step. The search for an ideal model must not become a "show stopper" for further development that is so urgently needed. Moreover, the Commission's "Green Deal" provides a way for experience to be integrated into standard setting; experience that another standard setter lacks and would have to build up.

Ideally, a European standard would also serve as a "blueprint" for an international standard. According to the afore-mentioned Cogito paper, the final solution would be an integrated standard setter under the umbrella of the existing IASB structure. Analogous to the current modus operandi for IFRS, an opening clause and inclusion in the European endorsement process would be required.

Support for integrated reporting

Despite past efforts to achieve integrated reporting, financial and non-financial information is still mostly presented in a largely disconnected way (at least without a common monetary basis). We therefore support the notion of "connectivity" (see q. 16 of the consultation document) as a superior way to improving the flow of information to stakeholders.

The current communication of the financial performance and position of an entity by way of financial statements is no longer sufficient. Indeed, today's conception of accounting must therefore be developed further towards integrated reporting. Ideally, the development of a European (later international) non-financial reporting standard should focus on achieving such an integrated solution from the outset. Since this would require considerable (additional) time, we suggest the further development and clarification of the existing NFI reporting requirements could conceivably be an appropriate solution in the medium term. The World Economic Forum's ESG indicators might be used. In the short term, NFI reporting should be a firm part of the management report and not presented at different times and in places. This also reflects the

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character of non-financial information, which (at least) with some time lag may also have financial consequences for an entity (e.g. through reactions from consumers, investors, etc.) and can therefore also be referred to as "pre-financials".

Assessment of non-financial information required

It seems obvious that monetarisation of (hitherto) non-financial aspects (CO2 price, pricing of occupational safety, education and training, etc.) could lead entities to report of a more genuine "total profit and loss account" than at present, which can be used both to measure the achievement of objectives and to assess future success.

The IDW therefore supports various initiatives, including the *Value Balancing Alliance* (VBA), which explicitly follows such an approach and thus differs significantly from the numerous and very heterogeneous other approaches. For this reason, the EU Commission has recently entrusted the VBA with work on the (supplementary) development of a new uniform standard for the measurement and monetary assessment of environmental impacts of companies. A genuine development of the existing reporting structure in the interests of a broad circle of stakeholders therefore seems achievable in the next few years. Integrating this into the governance structure of companies ("Integrated Thinking") will then initially be the task of management and supervisory boards.

Audit and assurance engagements in regard to non-financial information

Assurance as to the reliability of non-financial information is required

The current NFRD does not require any assurance engagement be performed in regard to non-financial information, since only an existence check is required. As mentioned above, this is what has been transposed into German law. Some stakeholders are already questioning the lack of discipline by preparers of NFI reports as well as the lack of a mechanism to sufficiently ensure the reliability of the reported information.

Indeed, some quarters specifically contend that a lack of validation, e.g. by the auditor, [hinders] the comprehensive integration of relevant and material sustainability factors in the investment and lending processes. They suggest

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that an efficient steering function of the financial service sector has not yet been achieved as a result.

As financial and non-financial information are increasingly perceived to be of very similar or equivalent importance to stakeholders, and given the benefits associated with achieving connectivity between the two, there is no longer sufficient justification for the current requirement whereby financial information reported in an entity's financial statements is subject to audit but the content of non-financial information reported to no form of assurance relating to its content.

The IDW therefore advocates a mandatory approach to reasonable assurance for both financial and non-financial information, including the respective underlying reporting systems as currently is the case under the ISAs applicable to financial statements. Since the reasonable level of assurance obtained by an auditor during the audit of financial information is undisputed, non-financial information should also be subject to reasonable assurance. For a (short interim, possibly three years') transitional phase (mandatory) assurance engagements with limited assurance on NFI might be useful.

Prerequisites for the provision of assurance services

As explained above, the IDW believes the previous justification for not subjecting NFI to independent assurance is rapidly diminishing. However, where suitable reporting systems first need to be established, the reporting entities affected will need a period of grace before it makes sense to subject their NFI reporting to an assurance engagement.

In this context, we are aware that there may be some misunderstanding regarding the difference between a reasonable and a limited assurance engagement. The difference is solely in terms of the work effort, (a reasonable assurance engagement involves different procedures and more work than a limited assurance engagement) but the prerequisites (see below) are identical. Consequently, an insufficiently mature NFI-accounting system cannot be "dealt with" in a limited assurance engagement in the belief that it is not sufficiently mature for a reasonable assurance engagement.

In developing a regime for independent assurance on NFI reporting, the prerequisites for the following essential aspects need to be considered:

what is needed to ensure NFI is assurable?

what are the necessary attributes for an assurance services provider?

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The International Auditing and Assurance Standards Board (IAASB) has established these prerequisites for audit and assurance engagements.

To ensure NFI is assurable, the matters upon which are being reported in the NFI must constitute appropriate underlying subject matter and the NFI must be prepared in accordance with suitable criteria as defined by ISAE 3000 (Revised). NFI reporting standards should be designed to ensure this, and these would also need to be made available to interested stakeholders. Also, management would need to acknowledge its role in preparing the NFI reporting, establishing the entity's underlying reporting systems etc. and facilitating full access to all the information and sources of information requested by the assurance services provider.

A suitable assurance services provider would need to possess appropriate assurance skills and techniques that are distinct from expertise in the underlying subject matter (see the definition in ISAE 3000.12(b)). In addition, an assurance services provider should be able to demonstrate adherence to appropriate assurance standards, ethical requirements, and quality control standards. Of course, professional education is a key factor, and in the area of NFI a multidisciplinary team would be appropriate to ensure the team in total has suitable expertise in various different aspects of NFI. The IAASB and the International Ethics Standards Board for Accountants (IESBA) have issued professional standards and requirements covering each of these aspects. Other assurance services providers may not necessarily meet all of these requirements.

The auditing profession in Europe, and in particular the German profession of Wirtschaftsprüfer, is well placed to fulfil the prerequisites to perform assurance engagements on a range of subject matters. According to information from our members, the German profession of Wirtschaftsprüfer currently performs approximately 98% of the assurance engagements relating to NFI reporting performed on a voluntary basis in Germany. We believe that the depth and breadth of understanding of the entity and its environment that the statutory auditor possesses is invaluable for a quality assurance engagement in respect of NFI.

Effects of the Corona Pandemic

The social and economic impact of the coronavirus pandemic have meant that sustainability issues have initially receded into the background. Some parties

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advocate slowing down progress on sustainability matters which they see as an unaffordable luxury at present.

The IDW expressly cautions against this. The effects of the coronavirus pandemic reveal numerous interactions with sustainability efforts. In our opinion, there is no contradiction between the lessons learned from the coronavirus pandemic and the pursuit of sustainability goals - rather the opposite is more likely to be the case. There are many opportunities to overcome the consequences of the pandemic in a sustainable manner.

We would be pleased to provide you with further information if you have any additional questions about the content of this letter, or to discuss our views with you.

Yours sincerely

Klaus-Peter Naumann
Chief Executive Officer