PRI RESPONSE

SMARTER REGULATION NON-FINANCIAL REPORTING REVIEW

16 August 2023

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To inform this briefing, the following investor group has been consulted: PRI Global Policy Reference Group. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing]

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United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Department for Business and Trade (DBT) and Financial Reporting Council's (FRC) review into non-financial reporting requirements in the UK.

ABOUT THIS CONSULTATION

The DBT and FRC are reviewing the non-financial reporting requirements in that UK companies need to comply with to produce their Annual Reports and meet broader requirements outside of the Companies Act. The review seeks to uncover opportunities to streamline the current non-financial reporting requirements, to best ensure that the framework is fit for purpose and delivers decision-useful information to the market. It builds on the UK Government's wider vision for smarter regulation to grow the economy.

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KEY RECOMMENDATIONS

Corporate reporting plays a critical role in ensuring that companies are held accountable for their impact on people and the planet. This review is an opportunity for the DBT and FRC to increase the consistency, reliability, and comparability of non-financial corporate reporting. Greater prescriptiveness and clear requirements from regulators result in more uniform reporting, which will provide decision-useful information to investors and lead to more informed capital allocation decisions and stewardship activities. Here, an effective reporting regime can help deliver on sustainability goals.

The DBT and FRC's proposals should support implementation of the first phase of the Greening Finance Roadmap; informing investors and consumers. Adequately measuring companies' role, performance, and impact on sustainability matters is crucial to the implementation of the Roadmap, the UK Government's updated Green Finance Strategy, and successfully redirecting private and public capital to support the sustainable transition of the UK economy. Implementing non-financial reporting standards is instrumental to help companies provide relevant information that is needed by all users of such data and in line with UK goals and commitments on climate, the environment, and human rights.

The PRI's key recommendations are set out below.

- Further research should be undertaken to determine a **risk threshold.** The risk that the company poses to stakeholders and society is a more important criterion of reporting requirements than size**.** For higher-risk companies, scope 3 emissions must be reported.
- At a minimum, the UK government should commit to implementing **the International Sustainability Standards Board's (ISSB) general requirements standard (IFRS S1) and climate standard (IFRS S2)** on an economy-wide basis by 2025 at the latest, with a one-year phase-in for reporting on non-climate sustainability-related risks and opportunities in line with the approach within ISSB Standards.
- The significant benefits and **longer-term vision of a fit-for-purpose** corporate reporting structure far outweigh the short-term costs of reporting non-financial information.
- The UK should adopt the term "**Corporate Sustainability Reporting Requirements" (CSRR)** and shift away from loaded language on "non-financial."
- The DBT and FRC's proposals for a new regime must ensure that non-financial reporting requirements are kept **mandatory** to ensure high quality reporting, which is often lacking in comply or explain requirements.
- To meet investor data needs, coherency within the **UK's Sustainability Disclosure Standards (SDS)** and non-financial reporting requirements should be ensured. An equivalency exercise should map out and address any overlap with the **Financial Conduct Authority's (FCA) Sustainability Disclosure Requirements (SDR), the FCA's Listing Rules, and the Companies Act requirements.**
- Specific indicators should be provided for companies reporting on **impact**, taking into account that time horizons and quantitative disclosures are not always applicable. The DBT and FRC should ensure that requirements on impact measurement do not create unreasonable or disproportionate challenges for companies actively seeking positive sustainability impacts.

- The PRI supports the FRC's proposal of a **Public Interest Report**, which would offer information about the impact of the business to the company's stakeholders and society. This should be brought into consultation, articulating the rationale for the Report, content, challenges it seeks to overcome, a risk assessment, and clear guidance on producing the Report.

DETAILED RESPONSE

SECTION 1: PREPARERS OF NON-FINANCIAL INFORMATION

Question 1: How valuable, if at all, is the preparation and/or disclosure of non-financial information for the effective running of your company? And why?

Disclosure of non-financial information

Access to consistent, comparable, and reliable non-financial data is crucial for responsible investors. This data is needed to **ensure efficient capital allocation and investee engagement**, which accounts for sustainability-related risks and opportunities as well as addressing sustainability goals.

Non-financial information is a crucial building block to a just transition to a net zero economy. Jackson et al. examined the effects of non-financial disclosure of corporate social responsibility in 24 OECD countries and found that **firms in countries requiring non-financial disclosures adopted significantly more corporate social responsibility activities**.[1] Such activities cover a wide range of sustainability topics such as carbon neutrality, responsible development, equality diversity and inclusion and planet resource preservation.[2] Non-financial disclosures enable and promote action on a wide range of societal issues.[3]

Aside from social benefits, the economic value of non-financial reporting is well researched and widely accepted.[4] Studies show that sustainability reporting is financially sensible for companies, as **firms with a higher corporate social responsibility performance than industry counterparts enjoy a reduction in the cost of equity capital** after they initiate reporting.[5] External factors such as the growing influence of global enterprises, the intensified scrutiny of corporate impact on the society and economy, and rapid growth around responsible investment, are cited as the crux of this link.

PRI recommends that **United Nations Guiding Principles (UNGP) and OCED Guidelines for Multinational Enterprises should be considered** when developing non-financial reporting. For example, meaningful disclosure of human rights performance can play a significant role in reducing a company's human rights risks and negative impacts, contribute to a company's competitive advantage by attracting investors and customers, and strengthen its long-term financial stability.

Global policy convergence around the UNGPs and OECD Guidelines for Multinational Enterprises is already heeding the call for expanded and aligned non-financial reporting. In its current state, the EU's Corporate Sustainability Due Diligence Directive (CSDDD) is calling for due diligence in line with the

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[1] Jackson, G, et al. (2020) "Mandatory Nonfinancial Disclosure and Its Influence on CSR: An International Comparison." J. Bus. Ethics, 162, 323–342.
[2] Nick Robins, Sabrina Muller, and Katarzyna Szwarc, (2021) "From the grand to the granular: translating just transition ambitions into investor action." Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy, London School of Economics and Political Science.
[3] Fiechter, Peter, Jörg-Markus Hitz, and Nico Lehmann. "Real effects of a widespread CSR reporting mandate: Evidence from the European Union's CSR Directive." *Journal of Accounting Research* 60.4 (2022): 1499-1549. Jouvenot, Valentin, and Philipp Krueger. "Mandatory corporate carbon disclosure: Evidence from a natural experiment." *Available at SSRN 3434490* (2019). Christensen, Hans B., et al. "The real effects of mandated information on social responsibility in financial reports: Evidence from mine-safety records." *Journal of Accounting and Economics* 64.2-3 (2017): 284-304. Christensen, Dane M. "Corporate accountability reporting and high-profile misconduct." *The Accounting Review* 91.2 (2016): 377-399.
[4] Dhaliwal, Dan S., et al. "Voluntary nonfinancial disclosure and the cost of equity capital: The initiation of corporate social responsibility reporting." *The accounting review* 86.1 (2011): 59-100. Cheng, Ioannou and Serafeim (2014) 'Corporate Social Responsibility and Access to Finance' and Serafeim (2020) 'Social-Impact Efforts That Create Real Value'.
[5] Dhaliwal, Dan S., et al. "Voluntary nonfinancial disclosure and the cost of equity capital: The initiation of corporate social responsibility reporting." *The accounting review* 86.1 (2011): 59-100.

UNGPs and OECD Guidelines. It is therefore crucial that the DBT and FRC facilitate harmonisation of non-financial disclosures to ensure that investors have meaningful and comparable information linked to human rights risks which can inform company investment decisions.

Non-financial information is already required in instruments such as the Modern Slavery Act and serves as a crucial means of enhancing transparency. This was further enhanced through the UK Government's commitment to strengthening section 54 (transparency in supply chain requirement).

In our report "Managing human rights risks: What data do investors need?" we interviewed 15 asset managers, asset owners as well as two service providers to understand their data needs. We found that investors are cognisant of human rights regulatory developments and as such require data that will enable them to meet their own responsibilities in line with these standards. Specifically, we found that the type of information needed by investors falls under four categories:

- companies' inherent human rights risks;
- how the board and leadership embed commitments in company culture and practice;
- the quality of company human rights due diligence; and
- positive human rights outcomes to which companies have contributed to.

The disclosure of non-financial information is essential to meeting these data needs and enhancing the extent to which investors can address human rights risks.

Preparation of non-financial information

In preparing non-financial information, companies need to **measure** their non-financial performance. This enables companies to understand and subsequently **manage** their non-financial risks and opportunities. Research shows that "more and better non-financial reporting" can benefit markets and investors by **reducing information asymmetry, improving liquidity, lowering cost of capital, and lead to better capital allocation**. Additionally, entities are likely to **improve their overall performance** through mandatory disclosure requirements.[6]

Unlike financial reporting, preparing non-financial data provides awareness for companies of their interaction with the environment and society. Disclosing this broader information set allows stakeholders to understand a wider range of factors that can affect company performance in the short, medium, and long term. Having both financial and non-financial reporting requirements also improves users' wider understanding of financial performance.

Question 2: What challenges, or costs, if any, does the preparation, disclosure and distribution of non-financial information create for your company?

An industry-wide challenge is the **lack of governance structure for non-financial reporting**, which does not have the same level of processes and controls as financial information. As noted by the Institute of Chartered Accountants in England and Wales (ICAEW), full scope 3 emissions disclosures require data from supply and value chains, which is beyond the current boundaries of financial reporting.[7] In order to meet investor data needs, non-financial reporting needs a r**obust governance**

[6] Christensen, Hans B., Luiz Hail, and Christian Leuz. "Mandatory CSR and sustainability reporting: Economic analysis and literature review." *Review of Accounting Studies* 26.3 (2021): 1176-1248.
[7] ICAEW insights, "Non-financial reporting: preparing for take-off" (2021) https://www.icaew.com/insights/viewpoints-on-the-news/2021/dec-2021/nonfinancial-reporting-preparing-for-takeoff

structure in place, with **board oversight and a suitable reporting criteria around corporate sustainability**.

Regarding costs, companies face both direct and indirect costs of non-financial disclosures. Direct costs range from **human resources and information infrastructure needed** to measure, prepare, disseminate, certify, and assure the reports. Indirect costs include proprietary cost for disclosing too much business-specific information that could leave the business more vulnerable to industry competition, and compliance costs if disclosed information attracts lawsuits hence increase litigation risk.

As we highlight in question 4, the costs of reporting non-financial information are **justified by the corresponding benefits** to broader climate and sustainability goals.

Question 4: Please select the most applicable statement:

✘ The benefits of preparing and disclosing non-financial reporting information outweigh the costs

☐ The costs of preparing and disclosing non-financial reporting information outweigh the benefits

☐ The benefits of preparing and disclosing non-financial reporting information are proportionate to the costs

☐ Don't know

Please explain your answer.

For the reasons detailed in our response to question 1 on the value of non-financial reporting, the benefits of preparing and disclosing non-financial reporting information **far outweigh the costs**. The impact assessment accompanying the EU's CSRD proposal and linked research from the Centre for European Policy Studies (CEPS) clearly demonstrate that **mandatory sustainability reporting will bring clarity to businesses, help reduce the number of requests for sustainability information from external stakeholders and lead to a reduction in cost in the medium- and longer-term**.[8]

Corporates respond to mandatory reporting requirements by making real changes to their business operations, due to stakeholder pressure and peer benchmarking. These long-term improvements can have additional short-term costs to implement changes within business practices. The benefits from mandatory non-financial reporting requirements **mitigate external costs**: it is less costly for stakeholders to acquire and process relevant non-financial data if companies disclose it already.

The DBT and FRC should **offer appropriate guidance on measurement of non-financial factors**, which would help reduce the costs associated with non-financial reporting. A balance should be struck between the costs incurred of measuring data and safeguarding its reliability and validity. Companies are currently reporting against many different sustainability standards, regulations, and investor requests, which can be resource intensive. As noted in our response to question 13, **adoption of IFRS S1 and IFRS S2** would help to address these challenges and reduce fragmentation.

Additionally, standardising reporting requirements can **reduce reporting burdens** by preventing companies from having to provide different data to each interested stakeholder on an ad hoc basis.

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[8] Eurosif, (2022) "CSRD – Why we need to get improved corporate sustainability data by 2024."
https://www.eurosif.org/news/csrd-why-we-need-to-get-improved-corporate-sustainability-data-by-2024/

Instead, through standardisation, stakeholders will receive the data they need, with the confidence that it is reliable and comparable.

Research also highlights that mandatory disclosure **is a crucial aspect of investor protection**, can assist in rectifying imperfect information, overcoming the insufficient supply of information, and achieve the **optimum quality of information for investors**.[9]

Question 5: To what extent do the Companies Act non-financial reporting requirements align with other regulatory requirements your company might be in scope of?

Alignment within the UK's broader sustainable finance structure is imperative. This means ensuring a coherent approach across the non-financial reporting requirements, the upcoming SDR, human rights policy and climate targets. This response assesses alignment with each of these aspects in turn.

SDR

The non-financial reporting regulation should increase investors' leverage to **finance the transition** by mandating disclosure against outcomes-focussed metrics. The current standards set by Companies Act non-financial reporting requirements have fallen below the FCA's proposals for the SDR and investment labels regime. The sustainable improvers label acknowledges the important role of stewardship, including investee and policy engagement, as an effective tool for investors to shape positive sustainability outcomes. This category is aligned with the transition to a net zero economy, recognising investments with scope to improve their sustainability credentials, and allows investors to support and incentivise companies to transition.

Human rights

A recent PRI report shows that investors and data providers prefer for analysis of companies' social performance to be based on company disclosures that align with standardised reporting frameworks, as it increases the comparability of data. Improvements will also be needed in terms of data and assurance providers' capacity to source and verify non-financial information in line with relevant international standards. Data needs to be better integrated into the investment and stewardship process, for example through setting clear expectations to fund managers, focusing on high-quality Human Rights Due Diligence (HRDD) and better mapping of a company's value chain.

Impact

It is imperative that the DBT and FRC's review of non-financial reporting requirements does not create **unreasonable or disproportionate challenges** for companies who are actively seeking positive sustainability impacts. In terms of impact measurement considerations, **specific indicators need to be developed**, especially considering that there are currently no plans in place to implement a UK social taxonomy.

To provide a meaningful assessment of impact, the DBT and FRC should **offer guidance on appropriate metrics** that are contextualised by explaining their relationship with the UK's climate targets. It should also be noted that applying timescales to impact measurement can lead to problems. The DBT and FRC's requirements should consider these nuances and allow for flexibility in disclosing targets and progress overtime. Research has shown that two thirds of individual investors

[9] Wangwei Lin, (2022) "Corporate Non-Financial Reporting in the UK: Diversions from the EU Sustainability Reporting Framework" Sustainability 14, 9134.

would like to receive information about the impact and societal benefits of their investments alongside financial reports, which highlights a clear need for this information.[10] The PRI has further comments on impact assessments in our response to question 12.

[10] Morgan Stanley, Sustainable Signals: Individual Investors and the COVID-19 Pandemic (2021), available at https://www.morganstanley.com/assets/pdfs/2021-Sustainable_Signals_Individual_Investor.pdf, p. 9.

SECTION 2: USERS OF NON-FINANCIAL INFORMATION

Question 6: To what extent do you agree or disagree that non-financial information prepared by companies is useful?

- ✘ Strongly Agree
- ☐ Agree
- ☐ Neither agree nor disagree
- ☐ Disagree
- ☐ Strongly disagree
- ☐ Don't know

Please explain your answer.

Current reporting challenges

PRI signatory surveys have revealed that a lack of consistent and comparable sustainability information is a substantial barrier to responsible investment practices. For investors, selling and/or marketing products in the UK, access to comparable, consistent, and high-quality disclosures is even more important to meet the increasing sustainability-related disclosure regulation, such as the FCA's incoming SDR and the future UK Taxonomy.

As investor demand for additional reporting has risen, so has the size and complexity of annual reports. The DBT and FRC now have the opportunity to simplify and streamline these requirements by introducing high-quality standards based on a **shared understanding of the aims and purpose of non-financial reporting**. The 2014 Non-Financial Reporting Directive (NFRD), that currently exists in the UK as a legacy from the European Union, needs updating to maximise the value provided to users. The updated requirements should align with the UK's climate targets, the transition to net zero, and ambition to become a leading net-zero financial centre.

Opportunities to streamline

It is critical that the UK's updated non-financial reporting requirements **do not allow corporates to opt-out** of disclosing sustainability-related information. A **standardised framework is required to set a threshold** for corporate reporting in replacement of the many opt-in guidelines and frameworks that currently exist.

Rising demand has been met with a wide range of non-financial standards, guidelines, and frameworks. According to ICAEW, the proliferation of initiatives has led to a confusing landscape, which risks undermining the usefulness and credibility of non-financial reporting.[11] Research has highlighted overlap between the UK Government's Environmental Reporting Guidelines, Guidance on Strategic Reports produced by the FRC, ESG Reporting Guidance from the London Stock Exchange Group, Sustainability Self-Reporting Guidance produced by the Office of Gas and Electricity Markets, and Sustainability Reporting Guidance for Public Annual Reports set out by HM Treasury.

[11] ICAEW insights, "Non-financial reporting: preparing for take-off" (2021) https://www.icaew.com/insights/viewpoints-on-the-news/2021/dec-2021/nonfinancial-reporting-preparing-for-takeoff

Furthermore, in A Matter of Principles: The Future of Corporate Reporting, the FRC itself recognises that non-financial disclosure in the UK is dispersed and patchy and suggests there be a more holistic approach to reporting. Overlap within these guidelines and with other legislation should be streamlined in the DBT and FRC's review of non-financial reporting.

The existence of multiple guidelines can result in corporates choosing to only report against the most favourable guidelines to their current business practices. This disincentivises improvement in, and transparency around, a companies' sustainable practice. This could risk undermining the UK's broader goals of greening the financial sector and shifting towards a net zero economy. As highlighted by Travers Smith, "the Government expects entities to use the reporting not as a check-box exercise, but as a trigger for climate risk assessments and a reflection of the entity's climate impact, with a view to future improvement."[12]

Question 7: How, if at all, do you use non-financial information?

Evidenced in our response to question 1, there is a compelling use-case for mandatory non-financial reporting. A recent survey of 439 institutional investors reveals that the majority consider that climate risk reporting is as important as financial reporting, and one-third considers that climate risk reporting is even more important.[13] Demand has certainly grown, yet investor expectations are not being met. The PRI can facilitate discussions with the DBT, the FRC and the investor community on understanding sustainability expectations of investors.

Question 8: Which types of non-financial information are the most useful and/or which are the least useful?

As set out in the PRI's Investor Data Needs framework, for data to be decision-useful it must be **available, of sufficient quality and relevant** to either the investment decision-making process (i.e., material) or to investor reporting obligations, or to both.[14]

The framework also sets out expectations for relevant data, listed below.

- Information should capture the breadth of data types, which include inputs (e.g., context), outputs (operational performance) and outcomes (e.g., sustainability performance).
- Datasets should include contextual information.
- Datasets should include data at least at business entity level. In addition, data points should be easy to aggregate. However, more granular, activity-level information may be required with the increasing application of activity-based taxonomies, which will, in turn, influence investors' data needs.
- Datasets should not focus on only one time horizon. In addition, data points should be clear about the time horizon they refer to.

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[12] Travers Smith, (2021) "TCFD reporting as part of the Non-Financial Report." (2021) https://www.traverssmith.com/knowledge/knowledge-container/tcfd-reporting-as-part-of-the-non-financial-report/

[13] Krueger, P., Sautner, Z., & Starks, L. T. (2020). The importance of climate risks for institutional investors. Review of Financial Studies, 33(3), 1067– 1111.

[14] Khan, Mozaffar, George Serafeim, and Aaron Yoon. "Corporate sustainability: First evidence on materiality." *The accounting review* 91.6 (2016): 1697-1724. Serafeim, George, and Aaron Yoon. "Which corporate ESG news does the market react to?." *Financial Analysts Journal* 78.1 (2022): 59-78.

- Datasets should at least include quantitative and pre-defined qualitative metrics, and quantitative and pre-defined qualitative data points should be clearly defined and standardised.
- Datasets may need qualitative data to address specific data types (e.g. on process, about the corporate strategy) or to explain the quantitative data (e.g., for changes). Qualitative data should be informative either as an independent data point (e.g., on governance) or clearly explain quantitative data (e.g., for changes).
- Datasets should be clear about their reporting boundaries. In particular, data points should clearly specify the operational boundaries, irrespective of whether the data refers to a parent company, group or company's value chain.

Research indicates that non-financial information will be **least useful** if the data is unrealised, un-standardised across time and entities, not material to investment performance, too generalised, not quantifiable, too infrequently disclosed, and too imprecise.[15] Therefore, high-quality non-financial disclosures, outlined in the criteria above, are the necessary component of informed investment decisions.

Question 9: How easy or difficult is it to interpret non-financial reporting disclosures?

☐ Very easy

☐ Easy

☐ Neither easy nor difficult

✘ Difficult

☐ Very difficult

☐ Don't know

Please explain your answer

Alignment with financial information

When compared to financial reporting, non-financial reporting is more difficult to interpret. Research confirms that financial reporting has been well developed, with standardised rules, clear metrics, assurance, and verification requirements. On the other hand, non-financial reporting can be much more fluid, with wide discretion on companies to disclose what information they see fit, and how disclosures are undertaken.[16] Without mandatory standardised disclosure regulation and enforcement, Bingler et al. consider non-financial reporting "cheap talk."[17]

There is scope for the FRC to **expand its remit and cover non-financial reporting**. This would go some way to elevating non-financial reporting to a similar level as financial reporting, ensuring that it

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[15] Amel-Zadeh, Amir, and George Serafeim. "Why and how investors use ESG information: Evidence from a global survey." *Financial analysts journal* 74.3 (2018): 87-103. Ilhan, Emirhan, et al. "Climate risk disclosure and institutional investors." *The Review of Financial Studies* 36.7 (2023): 2617-2650.
[16] Georgina Tsagas and Charlotte Villers, (2020) "Why 'Less is More' in non-Financial Reporting Initiatives: Concrete Steps Towards Supporting Sustainability." *University of Oslo Faculty of Law Research Paper.no. 2020-15.*
[17] Bingler, Julia Anna, et al. "Cheap talk and cherry-picking: What ClimateBert has to say on corporate climate risk disclosures." *Finance Research Letters* 47 (2022): 102776..

is well understood, consistently followed, and overcomes current challenges. The interrelatedness of financial and non-financial reporting requirements should be clearly explained in the DBT and FRC's amendments to the current regime.

Terminology

The DBT and FRC should set out **stronger definitions** of the key concepts within non-financial reporting, as well as settling on a concrete definition of what non-financial reporting entails. Inconsistent terminology around "non-financial reporting" has added to market confusion. As highlighted above, language around "ESG reporting" and "sustainability reporting" has loosely been adopted, alongside non-financial. Studies have also shown that there is no generally accepted definition for "non-financial information"; it is ambiguous and multi-faceted.[18] This lack of common understanding can create low comparability and information gaps between companies with differing understandings. We recommend the UK adopt the term **"Corporate Sustainability Reporting Requirements (CSRR)"** to overcome this and solidify a departure from the previous NFRD.

Reporting should no longer be split between "financial" and "non-financial." It is now widely understood that ESG and sustainability information is inherently financial, as the long-term risks that climate change and other sustainability issues pose to companies, as well as medium and long-term value creation. For example, a factor that may have traditionally been seen as non-financial can an impact on an investee company's reputation, business model or governance and thus its value – and therefore could be considered a financial factor. The key question for an investor is not whether a given factor is "financial" or "non-financial" but whether it has a bearing on the **investor's investment objectives**, defined in accordance with applicable law. These factors are likely to be "financial" but may also include other objectives.[19]

Considering current barriers to interpreting non-financial reporting disclosures and the clear weighting towards financial disclosures in terms of ease of understanding, the DBT and FRC should model non-financial reporting disclosures to a similar approach as financial reporting requirements.

Question 10: How does non-financial information support your judgement in the following areas?

- How the directors of the company have fulfilled their duties;
- The performance of the company;
- The company's future strategy, opportunities and risk;
- The company's approach to societal issues such as modern slavery and the gender pay gap;
- Whether or not to invest in a company - please consider the types of non-financial information that is most and least useful, and how it compares to other factors or information in your response.

Comprehensive non-financial information supports investor's judgement of **all areas listed above**. Responsible investors need decision-useful data to inform their investment processes and reporting.[20]

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[18] Lara Tarquinio and Stefania Posadas, (2020) "Exploring the term "non-financial information": an academics' view." *Meditari Accountancy Research.*
[19] PRI, UNEP-FI, and the Generation Foundation. (2022) "UK: Integrating sustainability goals across the investment industry." Part of *A Legal Framework for Impact.* https://www.unpri.org/a-legal-framework-for-impact/uk-integrating-sustainability-goals-across-the-investment-industry/10582.article
[20] PRI, Understanding the data needs of responsible investors. (2022)

Developments in standards, rules and laws regarding non-financial disclosures need to address these data needs.

Governance considerations

The PRI strongly supports the UK Corporate Governance code's emphasis on the **responsibility of boards to evaluate non-financial factors**. In keeping with the International Corporate Governance Network's Principles, the PRI supports the notion that **boards should monitor and oversee non-financial information**, and make informed decisions based on this (Principle 6) and **be encouraged to provide meaningful and accurate information** about the company's performance, strategy, risks, and governance practices (Principle 7).

Non-financial reporting should also cover information about the board. To help investors understand how company directors' have fulfilled their duties, the DBT and FRC may consider providing guidance for companies to report on the following:

- information about the board's approach to the governance of material risks, including its approach to evaluating and monitoring non-financial factors;
- information about how the board and leadership help embed commitments into company culture and practice;
- information about the composition of the board including the make-up and remit of board committees and their activities; and
- information about the experience, competencies, and remit of individual board members.

Investor data needs

Mandatory non-financial regulation is crucial to protect investors. To rectify imperfect information, **amendments to the current regime must create an end-to-end disclosure framework** that will enable investors to scale up their contribution to the UK's transition to a net zero economy and wider sustainability goals. Further, to overcome the disconnect between investor expectations and companies supplying information, **non-financial reporting regulation must embed a long-term view** on director's duties, company performance and strategy, and approach to societal issues.

When deciding whether to invest in a company, some types of non-financial information are more useful than others. This is particularly important in the context of an investor's set of investment strategy and investment activities. The PRI's Investor Data Needs Framework details expectations for relevant data, ranging from datasets needing qualitative data to address specific data types or to contextualise the quantitative data, data sets should capture the breath of datatypes, which include inputs, outputs, and outcomes.

However, this data can only support investor judgement if it is consistent, comparable, and reliable. EY's Global Corporate Reporting and Institutional Investors Survey finds that whilst 99% of investors use companies' ESG disclosures as part of their investment decision-making, there is a disconnect between companies and investor expectations. EY diagnoses this disconnect as a tension between long-term value creation and short-term thinking, with current non-financial reporting failing to meet investor requirements and expectations. It is imperative that investors receive decision-useful information that enable an evaluation of a company's growth and risk. However, the regulatory landscape for effective non-financial reporting is not currently facilitating this, widening the disconnect. This will better enable investors to understand an asset's earning opportunities, exposure to risk, and market valuation, to inform capital allocation decisions.

SECTION 3: QUESTIONS AIMED AT ALL RESPONDENTS

Question 11: What changes, if any, would you like the UK Government to make to the current legal requirements for companies to prepare non-financial information, and why?

You may wish to consider:

- The merits and disadvantages of individual requirements;
- The level of difficulty in using or preparing certain types of non-financial information;
- Whether there are opportunities to rationalise or simplify reporting requirements.

To facilitate a usable non-financial reporting regime, the PRI recommends that the UK Government **increases the scope of companies subject to non-financial reporting requirements**. This is a politically responsible decision to level the playing field between companies. Many companies already prepare non-financial information on a voluntary basis, as part of the Glasgow Financial Alliance for Net Zero (GFANZ) or the Carbon Disclosure Project (CDP). See our response to questions 13 and 14 for more information. We also recommend the **introduction of mandatory standards to reporting**, evidenced in our response to questions 12 and 13.

Assurance requirements

Regulatory standards should be set, where non-financial reporting is prepared with the same principles and rigour as financial information. The UK Government should also **recognise that non-financial information is material for investment decision-making**, and that reported information needs to be accurate and reliable. Whilst we welcome the move from limited assurance to reasonable assurance, the standard of non-financial information reported, particularly sustainability information, has not reached a high enough quality for optimum assurance to take place. Here, sequencing is crucial, and therefore **regulatory guidance on metrics is needed to bring sustainability information to a higher standard** before stricter assurance requirements are put in place.

As shown in research by ICAEW, enhanced non-financial reporting can play a critical role in the transition towards more sustainable and resilient societies and economies.[21] The current non-financial reporting standards are not providing the decision-useful information that investors need. This can lead to greater greenwashing risks, be it intentional or unintentional. To give further weight to this, PwC's 2021 survey of 325 investors globally found that nearly 80% said they trust reported ESG information more when it's been assured. The challenge here is overreliance on third party assurance, and the unintended consequences this creates. These consequences range from data breaches, heightened regulatory pressure, unstructured monitoring process, and a lack of consistent methodologies of third parties leading to conflicting informational outcomes.

Currently, companies must disclose non-financial information in the Strategic Report section of their Annual Reports. As the FRC highlights, there is no overarching framework that covers both financial and non-financial reporting that meets investor and wider stakeholder needs, which has resulted in a lack of relevant, reliable, comparable and balanced information.[22]

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[21] ICAEW insights, "Non-financial reporting: preparing for take-off" (2021) https://www.icaew.com/insights/viewpoints-on-the-news/2021/dec-2021/nonfinancial-reporting-preparing-for-takeoff
[22] Financial Reporting Council (FRC) "A Matter of Principles: The Future of Corporate Reporting." Discussion Paper, 2020. https://www.frc.org.uk/getattachment/cf85af97-4bd2-4780-a1ec-dc03b6b91fbf/Future-of-Corporate-Reporting-FINAL.pdf

Proposal for a Public Interest Report

We support the FRC's proposal that non-financial information be included as part of the Annual Report, as well as a new Public Interest Report. We encourage the DBT and FRC to **develop a proposal for a Public Interest Report** and bring it into the final consultation. The proposed Public Interest Report is focused on how the business interacts within the wider ecosystem and intends to:

- provide information which enables users to understand how the company views its obligations in respect of public interest;
- how it has measured performance against these objectives; and
- provide information on future prospects in this area.

The PRI envisions that the **Public Interest Report** will provide consistent and comparable information, underpinned by standards and metrics. This should include information about the impact of the business of the company's stakeholders and society. As the FRC highlights, this would incorporate existing mandatory reporting. For consultation respondents to grapple with the value of a Public Interest Report, it is imperative that the DBT and FRC articulate the rationale for the Report, its content, the challenges it seeks to overcome, a risk assessment, and clear guidance on producing the Report.

Alignment with the UK's broader disclosure framework

For an effective reporting framework, regulators should ensure **coherency between the FCA's SDR, the FCA's Listing Rules, and the Companies Act requirements**. We recommend that the DBT and FRC undertake an analysis to uncover equivalency between these requirements. For example, whether SDR reporting could be sufficient for financial market participants to demonstrate compliance with certain non-financial reporting requirements. This equivalency matching could reduce reporting burdens and allow for greater coherence between the two regimes. Enabling cross referencing to different reporting requirements could avoid an increased burden on financial market participants, while ensuring sustainability information reaches the key stakeholders.

An integrated vision of the UK's broader disclosure framework by government and regulators should underpin the DBT and FRC's review into non-financial reporting. The UK has established strong leadership on mandating disclosure of climate risk and carbon reduction. However, **the transition to a net zero economy requires a whole-of-government approach**, for which a fit for purpose disclosure framework is an essential element.

Question 12: Thinking about the future of your organisation and the UK's transition to a net zero economy, what changes, if any, do you think may be required to the type of non-financial information produced to guide decision making, and why?
You may wish to consider whether additional information is required to support decision making (such as Transition Plans and Green Taxonomy disclosures covered by the recently published Mobilising Green Investment: 2023 Green Finance Strategy).

Credible transition plans

The UK's non-financial reporting requirements should mandate companies to prepare transition plans and disclose the scenarios used for these plans. These plans should be accompanied by key assumptions underpinning these scenarios. As the Climate Change Committee's 2023 report highlights, the policy frameworks for the transition to net zero must develop urgently to meet future

targets. Investors need comprehensive information on how companies intend to decarbonise their operations and value chain. A review of non-financial reporting requirements presents a unique opportunity to bring such transparency in the UK.

For consistency and comparability of reported information, **the UK should adopt ISSB standards, including the requirements on transition plans**. These measures will ensure that the UK contributes to the establishment of a common baseline. Should the UK's reformed non-financial reporting regime lower the threshold, this could have detrimental impacts for global sustainability reporting more broadly, as well as the global transition to net zero.

Taxonomy

The development of a **UK Green Taxonomy** should establish a clear definition of investments and economic activities that can be considered green and sustainable, with the view of channelling finance into the net zero transition. The taxonomy is a useful tool, that is part of a much broader disclosure framework. Ensuring that the **whole framework is credible, science-based, and usable** – through consistency with the FCA's SDR regime and the DBT and FRC's non-financial reporting regime, should be the priority.

Additional disclosures

The UK should also consider **complementing these requirements with additional disclosures developed through the Transition Plan Taskforce**, and work done for the EU Corporate Sustainability Reporting Directive (CSRD), which provides investors with the transparency needed to finance the objectives of the EU Green Deal.[23]

Further considerations

We are supportive of the inclusion of both **quantitative and qualitative reporting requirements**. However, we advise against requiring quantitative disclosure where such metrics may be unavailable. Assessing impact often centres on the below concepts.

- **Concept of contribution**: "a credible narrative, or thesis, which describes how the actions of the investor will help achieve the [impact] goal or how the outcome would not have occurred without the investor's involvement." "This reference to a 'credible' narrative reflects the point made above: it will rarely be possible to attribute the occurrence of a particular sustainability outcome to a single activity or measure the precise difference that the activities of a single investor have made to that outcome. Because of that, the emphasis may often need to be on the basis for and quality of the investor's explanation for the difference it has made."
- **Concept of additionality**: "outcomes are assessed against the situation that would have prevailed without the relevant intervention (a 'counterfactual') to establish whether there has been an increase in the quantity or quality of the positive sustainability outputs of a given enterprise."[24]

A balance should be sought between narrative qualitative information included in the non-financial and strategic reports, and quantitative information. The DBT and FRC could set out core qualitative indicators to help companies compare performance and thus inform capital allocation decisions.

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[23] Eurosif and PRI letter on "Ensuring a future-proof sustainability reporting framework that supports meaningful transition efforts" (2022) https://www.eurosif.org/wp-content/uploads/2022/04/Joint-sustainable-investment-industry-letter-re.-the-necessity-of-net-zero-disclosures-in-CSRD-COM.pdf
[24] Freshfields Bruckhaus Deringer, A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making, available at https://www.unpri.org/download?ac=13902 p. 44-45.

Furthermore, considering the UK's commitment to net zero by 2050, forward looking information is increasingly critical to help investors assess company performance. Therefore, there is a strong use case for the DBT and FRC to offer **Key Performance Indicators (KPIs)** to guide company reporting requirements.

The DBT and FRC can shape the non-financial reporting landscape through setting **requirements that provide a level playing field**. Investors can inform corporate disclosure standards through **engagement with regulators**, such as the DBT and FRC. The PRI recommends that investors look for information about the quality of governance and managerial processes that shape how companies address, mitigate and remedy adverse impacts on people, rather than focus on the number of policies, meetings with stakeholders and other statistics that fail to provide real insight or measure progress. This reduces the onus on investors to interpret information that is credible from information that is imprecise.

Question 13: How should the standards being prepared by the International Sustainability Standards board (ISSB) be incorporated into the UK's non-financial reporting framework?

The PRI recommends that the UK government commit to implementing the **ISSB general requirements standard (IFRS S1) and climate standard (IFRS S2) on an economy-wide basis by 2025 at the latest,** with a one-year phase in for reporting on non-climate sustainability-related risks and opportunities in line with the approach within ISSB Standards.

The ISSB's standards are based on the framework established by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), which have already been implemented within the UK regulatory framework. Therefore, adoption of the ISSB standards is a natural next step to build on the progress already made through TCFD and harmonise requirements across jurisdictions, all the while limiting adjustment costs for users and preparers alike.

To better meet the breadth of investor data needs, the UK government should consider adopting disclosure requirements additional to the ISSB Standards that capture further information on companies' sustainability impacts, in line with the IFRS Foundation's "building blocks" approach. In addition to sustainability-related information on a companies' risks and opportunities, investors increasingly need information to assess and interpret a company's sustainability performance and their alignment with sustainability goals and thresholds. The ISSB Standards are not expected to enable disclosure of these elements of corporate reporting in full, particularly for sustainability issues other than climate change[25]. In doing so, the government should build on requirements within the **Global Reporting Initiative (GRI) Standards and European Sustainability Reporting Standards (ESRS)** once finalised.

We recognise existing efforts to build on ISSB Standards, such as the work of the Transition Plan Taskforce to develop a gold standard for private sector climate transition plans. We support an **endorsement mechanism** for current and future ISSB standards to become part of UK law, and continued engagement with the ISSB Jurisdictional Working Group to promote interoperability.

[25] The prevailing standards and frameworks (including ISSB Standards and TCFD recommendations) recognise that the companies' (climate) impacts are, in most cases, financially material.

Question 14: To what extent do you agree or disagree that current size and company type thresholds for non-financial reporting information could benefit from simplification?

☐ Strongly agree

☐ Agree

✘ Neither agree nor disagree

☐ Disagree

☐ Strongly disagree

☐ Don't know

Please explain your answer.

You may wish to consider:

- The different scope requirements and the ease or difficulty of following these;
- Whether there are any size and/or type thresholds that are particularly well targeted, or by contrast, inappropriate or no longer fit for purpose;
- Application of exemptions and ease of use;
- How thresholds interact with requirements set by other regulators (for example the Financial Conduct Authority and Prudential Regulation Authority).

Simplification to the current thresholds is required, but **size should not be the determining factor** of reporting requirements. The most important criterion is the **risk** that the company poses to its stakeholders and society. **Further research should be done by the DBT and FRC to determine a risk threshold**, with high-risk companies subject to more stringent reporting requirements given their higher potential of causing damage to society and the environment. **A standardised and comparable risk scoring system for non-financial reporting should be created**, which could respond to industry challenges whilst being flexible to future risks.

Investors have indicated a need for sustainability-related information from all portfolio companies across sustainability-related issues, and that they expect this data to be reported **at least by all listed companies (except listed micro-enterprises) and large listed and non-listed companies**. Different timings for implementation measures (e.g., phase-in) may be used to achieve proportionality where necessary.

Reporting requirements based on the size of a company are overwhelmingly narrow and simplistic. **Companies' size is not always proportionate to the sustainability risks, opportunities, and impacts that those companies have.** Small and medium-sized enterprises (SMEs) account for the majority of private sector GDP, and likely make up a significant share of private sector sustainability impacts. Therefore, it is inappropriate to determine reporting requirements based on company size. SMEs and large companies are also an important part of the reporting chain. A lack of reporting requirement is a barrier for investors subject to specific disclosure requirement. It is also an internal risk for companies if they are unable to account for non-financial impacts.

The PRI recommends that **all companies should be required to disclose to some extent**. Requirements should be proportionate to, but not dependent on size. To avoid ambiguity and subjectivity on whether a company or sector falls under a high-risk category, the DBT and FRC should

look to existing guidance by the OCED. The OECD has already released sector-specific guidance on disclosure requirements for high-risk sectors, which the DBT and FRC should consult for high-risk sectors to introduce more stringent requirements.[26] For higher risk companies, scope 3 emissions should be reported in order to understand the wider impact that the entire value chain of a high-risk company, as well as efforts to mitigate negative impacts through a credible transition plan. Sector specific guidance could also help reduce the burden on SMEs subject to reporting burdens, which naturally face stronger resource challenges than larger entities.

Question 15: The Companies Act 2006 sets out size categories for UK companies that determine the type of accounts that need to be prepared and filed with Companies House.

2 of 3 out of:	Micro	Small	Medium	Large
Annual turnover (£)	≤632k	≤10.2m	≤36m	Any company not meeting medium threshold
Balance sheet total (£)	≤316k	≤5.1m	≤18m	
Average number of employees	≤10	≤50	≤250	

Do these size thresholds remain appropriate?

☐ Yes

✘ No

☐ Don't know

Please explain your answer and what, if any, changes you would like to see.

As outlined in our response to question 14, the PRI does not support size-based reporting requirements.

Question 16: Do you have any other comments that might aid the consultation process as a whole?

Additional considerations from the PRI are set out below.

- **Monitoring and evaluation:** The DBT and FRC must also commit to consistent monitoring and evaluating progress of any proposals, to ensure that the regime delivers on its aims and overcomes the current challenges.
- **Timeline:** A consultation on non-financial reporting requirements will be important to investors. This consultation and subsequent implementation of a new regime should factor in **reporting cycles** to its implementation. Sustainability information must be available in a

[26] OECD Due Diligence Guidance for Responsible Business Conduct (2018). https://www.oecd.org/investment/due-diligence-guidance-for-responsible-business-conduct.htm

timely manner to ensure that financial market participants can fulfil their own disclosure obligations. Any delay will have a negative impact on the ability of companies and financial market participants to support the sustainability transition of our economy.

- **Assurance:** HM Treasury's 2021 Greening Finance: A Roadmap to Sustainable Investing mentions non-financial information, although it is done in relation to the Taskforce on Climate-related Financial Disclosures (TCFD). It only provides guidance on climate-related financial disclosures and noticeably overlooks the role of non-financial disclosures. However, the 2023 updated Green Finance Strategy recognises the need to complement SDR with the UK's wider legal framework for non-financial reporting and commits to a review, recognising that this information is material for investment decision-making, and that reported information needs to be accurate and reliable. We welcome the introduction of a UK-wide assurance requirement and encourage regulators to provide a clear timeline for moving from limited assurance to reasonable assurance with pace.
- **Net-zero requirements**: A non-financial reporting regime that does not contain **robust, granular requirements around net-zero commitments** would be a missed opportunity for the UK to future proof its sustainability reporting framework and equip investors with the tools they need to finance the net-zero transition.
- **Beyond disclosure:** The UK sustainable finance regulatory framework is focused on **disclosures**, which is a good starting point for directing capital towards shared societal goals. To embed a more sustainable financial system, more guidance should be given on **stewardship frameworks and regulation, taxonomies, and reforms to investor duties and disclosures**.[27]

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the DBT and FRC further to non-financial reporting requirements in the UK.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org

[27] PRI. (2022) "A sustainable finance policy engagement handbook" https://www.unpri.org/policy/policy-engagement-handbook