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Delegations will find attached a proposal from the Commission, submitted under a covering letter from Mr Jordi AYET PUIGARNAU, Director, to Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union.

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COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups

{COM(2013) 207 final}
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1. INTRODUCTION

Non-financial information is generally considered as environmental, social and governance (ESG) information. This includes information concerning diversity, as a board's composition is an integral element in the corporate governance of a company. Such information can be disclosed in the form of a statement in the annual reports, a separate corporate governance statement, a separate report, a website, etc.

The formal disclosure of ESG information is currently addressed in EU legislation by the Accounting Directives[1] (hereinafter AD). However, the need to improve transparency in this field has been highlighted in the Single Market Act[2], and recently reiterated by the CSR Communication[3]. This Impact Assessment considers the case for improving the disclosure of non-financial information by EU companies as part of a broader set of initiatives on corporate governance and CSR aimed at creating a highly competitive social market economy.

2. PROBLEM DEFINITION

The Commission services have identified two main issues concerning (1) the inadequate transparency of non-financial information and (2) the lack of diversity in the boards.

2.1. Inadequate Transparency of Non-Financial Information

Although a positive trend can be observed, the majority of large EU companies fail to adequately meet growing demand from stakeholders (including investors, shareholders, employees and civil society organisations) for non-financial transparency. Specific issues have been highlighted with regard to both **quantity and quality of information** available.

– Quantity: it is estimated that only ~ 2500 out of the total ~ 42000 EU large companies formally disclose non-financial information on a yearly basis

– Quality: the information disclosed is often lacking in materiality, or not sufficiently balanced, accurate and timely. Specific information gaps are found with regard to material aspects concerning policies and risk-management, as well as on specific topical areas (human rights, corruption).

[1] Directives 78/660 and 83/349

[2] "Twelve levers to boost growth and strengthen confidence", COM(2011) 206

[3] "A renewed EU strategy 2011-14 for Corporate Social Responsibility", COM(2011) 681

The main drivers of this problem are identified in both a market and a regulatory failure:

Market failure: Market incentives appear insufficient or uneven. Although companies are increasingly under pressure to become more transparent, the benefits related to non-financial disclosure are often perceived as long-term and uncertain, while short-term costs are relatively high and easily measurable. As a consequence, externalities of potential relevance remain external to businesses' reporting

Regulatory failure: The majority of stakeholders consulted considered that the obligation set by the AD lacks of clarity, with prejudice for legal certainty. Some Member States' legislation already go beyond such obligation[4], however, national requirements appear significantly diverse, leading to difficulties to benchmark companies across the Internal Market.

2.2. Problem 2: Insufficient board diversity

Boards with members that have a similar educational and professional background, nationality, age or gender may be dominated by a narrow 'group-think'. Lack of diverse views, values and competences may lead to less debate, ideas and challenge in the boardroom. This may have a negative impact on the challenge and oversight of the management decisions by the board. Although the fragmentation of data makes it difficult to precisely assess the scale of the problem, it appears that the diversity of European company boards is rather limited.

Market Failure: Inadequate levels of board diversity are linked above all with insufficient market incentives for companies to change the situation. In this respect, *inadequate recruitment practices* for board members contribute to perpetuating the selection of members with similar profiles. *Inadequate level of transparency* on board diversity reinforces the problem. Information provided by companies does not reveal the board's approach on diversity in the selection process, the objectives envisaged or how they have been reached.

Regulatory Failure: The market failures have not been sufficiently corrected by appropriate regulation. At the EU level there are no rules regarding specifically board diversity and although some Member States have adopted certain provisions (i.e. to increase gender diversity), there are considerable differences between their approaches.

Such problems pose further prejudice to specific stakeholders groups (ie companies, investors, NGOs, public authorities). They have a negative impact on **performance** (companies' non-financial risks and externalities are not adequately taken into account); on **accountability** (as companies cannot be held fully accountable for their impact on society; **efficiency of financial markets** (as investors fail to build relevant information into their decision-making processes).

2.3. How will the problems evolve without action?

At the global level, several initiatives provide non-binding guidance for companies[5]. However, in contrast with financial information, currently there is no generally accepted standard-setter for non-financial information. Initiatives on diversity are also fragmented and improvements over time have been limited. Action is needed as none of the existing

[4] Including the UK, Sweden, Spain, Denmark and France

[5] Such as the UN Global Compact, the OECD Guidelines for MNEs, the ILO Tri-partite declaration of Principles on MNEs, the ISO 26000, the UN Guiding Principles on Business and Human Rights, the Global Reporting Initiative

initiatives is expected to yield in the short term significant solutions to the problems identified.

2.4. Subsidiarity

Non-financial information is already partly regulated at EU level. However, the diverging approaches taken by Member States could determine even greater differences within the Internal Market, and sustainability-related information appears, by its own nature, as a cross-national matter. As regards diversity, current initiatives are much fragmented. In the absence of an action at EU level, in many Member States there will be no or very slow progress in the coming years. Coordinated action at the EU level is therefore necessary. The Treaty of the Functioning of the European Union allows action to be taken to address the identified problems[6].

3. OBJECTIVES

The overall policy objective of the proposal is to contribute to the Single Market's potential to create sustainable growth and employment. More transparency is considered key for companies to deliver better results and is expected to enhance the trust citizens have in business and in markets and enable a more efficient allocation of capital. In operational terms, the objectives of the proposal would be to

(1) increase the quantity of information (i.e. number of companies reporting)

(2) increase the quality of the information disclosed, and

(3) enhance diversity in the boardroom.

4. POLICY OPTIONS

4.1. Transparency of Non-Financial Information

In order to meet the objectives set out above the Commission Services have considered a number of policy options, based in particular on the form, content and reference of the disclosure and on the nature of the requirement, including:

(0) No policy change

(1) Require a non-financial statement in the Annual Report: this option would strengthen the existing provision by introducing minimum requirements on the content[7] of the disclosure.

(2) Detailed reporting: this option would require companies to provide information in the form of a stand-alone report in accordance with International Frameworks. Given the potential administrative burden, different kind of requirements have been considered:

6 See Articles 8, 10 and 11 TFEU

7 Social, human rights and anti-corruption matters would be added to current reference (*environment and employees*). Within these areas, the disclosure would cover (i) policies, (ii) performance, and (iii) risk-management, and should rely on existing international frameworks. Companies that do not have a specific policy would be at least required to explain why this is the case

(a) mandatory

(b) report or explain

(c) voluntary. This option would exempt companies choosing to provide a detailed report from other disclosure obligations, provided that such report complies with specific conditions[8].

(3) Set up a mandatory EU reporting standard.

The table below provides an overview of the analysis of the policy options

Table 1 – Assessment of the Policy Options

		Effectiveness		Efficiency (compliance cost)	Competitiveness	Coherence with EU legislation
		Quantity	Quality			
0. No change		0	0	0	0	0
1. Require a disclosure in the Annual Report		+	+	+	+	+
2.Detailed reporting	**a) Mandatory**	+	++	--	+/?	+
	b) Report or Explain	+/?	+	-	+/?	+
	c) Voluntary	?	+	+	+	+
3. Set up a mandatory EU standard		++	+	--	?	+

Magnitude of impact as compared with the baseline scenario (baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable (Commission Services Analysis).

4.2. Enhancing boards diversity

The Commission's services considered a number of policy options, including:

(0) No policy change

(1) Require companies to disclose their board diversity policy with regard to various aspects, including age, gender, nationality and educational and professional background in the corporate governance statement to be included in the annual report.

(2) Mandate companies to take into account diversity as one of the criteria for the selection of a board candidate.

[8] (i) It covers required content (ii) makes reference to international frameworks and (iii) is annexed to the Annual Report.

(3) Put on companies a binding obligation to establish a policy concerning diversity for boards[9].

It should also be noted that the option of introducing quotas has been discarded, as it is subject of a separate Commission initiative.

Table 4 – Assessment of the Policy Options					
	Effectiveness	Efficiency (Compliance Cost)	Competitiveness	Coherence with EU legislation	Estimated costs per company
0. No policy change	0	0	0	0	0
1. Disclosure of internal policy on diversity in the annual report	+	+	+	++	€600/1000
2 Diversity must be one of the criteria of Board composition	+/?	-/?	+/?	+/?	? possible costs linked to remuneration of HR specialists
3. Requirement to establish a policy with regard to diversity	+	-	-	-/?	? linked to remuneration of HR specialists and possible increase of board members
Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable					

4.3. Preferred Policy options

As regards transparency of non-financial information, having compared the broad policy options, the best alternative appears as a combination of Options 1 and 2c. Companies would be required to disclose material information in the form of a statement in their Annual Report. Companies willing to prepare a detailed non-financial report on a voluntary basis would be exempted from such obligation, provided that the report meets specific conditions.

Only large listed and non-listed companies having more than 500 employees would be subject to new requirement. It is estimated that this would cover ~18000 companies. Subsidiaries within a group would be exempted to the extent that their relevant information is integrated in the consolidated report of the parent company. Such policy is expected to determine a satisfactory increase in transparency, while keeping the administrative burden low.

As regards diversity, Option 1 is the preferred option. Companies would have to provide in their corporate governance statement information on their diversity policy, including aspects concerning age, gender, nationality and educational and professional background. The statement would present the objectives of this policy, its implementation and the results

[9] Companies would have to determine the content of this policy, establish targets and assess their achievement.

obtained. Companies not having a diversity policy would only be obliged to explain why this is the case. By enhancing transparency, this option would encourage companies to reflect more on the issue and take better account of the need for greater diversity in their boards while offering a great deal of flexibility.

In order to maintain coherence with existing requirements regarding the corporate governance statement, while avoiding to put additional burden on SMEs, only large *listed* companies would be required to provide information on board diversity policy.

5. ANALYSIS OF MAIN IMPACTS OF THE PREFERRED POLICY OPTIONS

5.1. Increased transparency

In general terms, the preferred options would lead to an increase in the quantity of information available compared to the baseline scenario. As regards non-financial disclosure, the reliance on international frameworks, should determine a limited improvement in the quality and comparability of the information disclosed. Should companies also decide to voluntarily provide a non-financial report, the level of detail of information disclosed would necessarily increase. As regards diversity, the provision would make available, often for the first time, information about a comprehensive set of diversity indicators.

5.2. Better companies' performance

Due to the nature of the proposal, benefits are in most cases difficult to quantify. Nevertheless, enhancing transparency at a limited cost, the proposal would have an overall positive impact on companies' performance, as non-financial risks and opportunities would be better measured and managed. Better non-financial performance is then related with lower cost of capital; better resources (including human capital) management; consumer loyalty and better management.

Furthermore, transparency would foster more diversity in the boardroom which is expected to lead to better oversight of the management by the board and to overall better decision-making processes.

5.3. Increased accountability

Material non-financial information would be made publicly available on a regular basis and could be used by civil society organisations and local communities to assess the impact and risks related to the operations of a company. More transparent reporting practices could also act as a catalyst for companies to increase and improve their CSR performance, or give them incentives to set up CSR policies for the first time, thus positively affecting the way companies are perceived by society. The potential increase in consumers' trust may also have a positive effect on the demand side.

5.4. Enhanced efficiency of capital markets

In the short term the proposed policy would respond to growing market-driven demand for more comparable and accurate information, allowing investors to develop more comprehensive valuation models. In the long term, it could consequently drive investors to take better account of sustainability considerations and overall performance. In relation to diversity, the proposed policy would enable investors to take better-informed decisions as to the governance practices of the company.

5.5. Increased administrative burden

The new disclosure requirement would be more costly than the business as usual scenario. Additional costs may relate to drafting, publication, specific staff training or data collection. The cost of the proposed disclosure is estimated to be between €600 and €4300 per year per company, thus generating a total cost between 10.5 and 75.25 million euros. Companies choosing to provide a detailed report on a voluntary basis might have to sustain higher costs but they would be exempted from the disclosure obligation[10].

The cost of disclosure of the diversity policy is estimated to be between €600 and 1000, generating a total cost between 3.6 and 6 million euros. As the preferred option would not apply to listed SMEs, its impact should be limited.

The proposed policy would not introduce new verification requirements. The increase in audit costs due to the proposal is expected to be a negligible.

5.6. Other impacts

5.6.1. Social Impacts

The measure could encourage boards to take higher account of social matters in their business strategies. Increased transparency could also support better employment relations, and contribute to reducing risks and costs associated with labour conflicts. More transparency on diversity at the highest decision-making level of the company could promote more diversity at all organisational levels. A more diverse board could better reflect stakeholders' diversity.

5.6.2. Environmental Impacts

The requirement to disclose material issues related to environmental policies and risk-management aspects is likely to trigger better resources' management and internal sustainability awareness.

5.6.3. Impact on Fundamental Rights

It is estimated that the preferred options would have beneficial impact on fundamental rights as they would encourage EU companies to review regularly their policies and internal procedures in various aspects, due in particular to a larger public scrutiny.

5.6.4. Other Economic Impacts

The measure will not have meaningful budgetary consequences for public authorities, nor implications for the EU budget.

5.6.5. Third countries and international aspects

The proposed policy would put the EU in a leading position at global level. It would be consistent with other third-countries initiatives, and potentially trigger their further

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10 Such cost is estimated in a range between €33000 and 604000, mainly depending on the size and complexity of the company and its operations

development. No significant effects on trade flows with third countries were identified nor signalled.

6. MONITORING AND EVALUATION

The Commission will monitor the implementation of the revised Directives in cooperation with the Member States throughout the implementation period. In compliance with the principle of subsidiarity, the relevant information should be gathered primarily by Member States through relevant agencies or Securities Markets' Regulators. The evaluation of effects of the preferred policy shall be carried out to see to what extent the anticipated impacts materialise.