Corporate Non-Financial and Risk Disclosure:

State of the Art and the Way Forward

The State of the Art on Non-Financial and Corporate Risk Disclosure in the Academic Literature

The first three months of the research project titled *"Fostering sustainability mindset: How non-financial disclosure and corporate risk assessment may drive ESG value creation"* (**prot. nr. 2022CTBNRN**, which received funding from the European Union Next-GenerationEU - National Recovery and Resilience Plan (NRRP) – MISSION 4 COMPONENT 2, INVESTIMENT 1.1 Fondo per il Programma Nazionale di Ricerca e Progetti di Rilevante Interesse Nazionale (PRIN) – **CUP N. H53D23002380006**) were dedicated to a systematic review of the academic literature on non-financial and risk disclosure. Articles published in journals of the greatest scientific impact which tackle these issues were analysed and their main conclusions synthesised to highlight key insights from previous works and avenues for future research. Such insights were subsequently aggregated to develop the main research questions of the project, which are presented in the next section of this communication.

Findings from past studies indicate that the quality and quantity of non-financial and risk disclosure have recently shown an increasing trend. Such an outcome is reportedly underpinned by two main driving forces, i.e., stakeholder concerns and regulatory requirements. Indeed, the introduction of regulatory provisions at the European Union (EU) level (e.g., Directive 2014/95/EU or the Non-Financial Reporting Directive) have placed coercive pressures on corporations to widen the extent of their environmental, social, and governance (ESG) disclosure. As such, a case has been made in past literature for the greater effectiveness of mandatory provisions over voluntary frameworks and standards. In particular, the Non-Financial Reporting Directive requires large undertakings to disclose the policies, outcomes, and risks related to certain ESG topics, namely environmental matters, social and employee-related matters, respect for human rights, and anti-corruption and bribery. Despite the recent increase in the volume of non-financial (risk) reporting, however, past studies suggests that the overall quantity of such disclosure remains moderate. Furthermore, non-financial (risk) information was found to be mostly backward- rather than forward-looking in nature, with an emphasis on positive outcomes. Corporate managers may therefore be trying to conceal negative information to prevent investor backlash and reputational damage. Overall, companies' approaches to risk reporting have been found to be short-sighted, particularly concerning climate- and pandemic-related risks. Past research has additionally lamented the lack of comparability of non-financial (risk) information across different companies, as no universal reporting framework had been made available to firms before the introduction of Directive 2022/2464/EU (or the Corporate Sustainability Reporting Directive). Thus far, companies have had access to a plethora of voluntary non-financial reporting frameworks, such as Integrated Reporting (IR) and the Global Reporting Initiative Standards, which has resulted in the absence of a standardised and shared approach to ESG disclosure. Reporting consistency has also been highlighted as an area of concern owing to companies' use of separate reports to communicate different types of information, or the distribution of closely related information across separate sections of a unique report.

Insights from the academic literature entail that the double materiality approach introduced by the European Commission in 2019 could help to solve the challenges currently bearing down on non-financial reporting practices. Indeed, IR has been criticised in previous works due to its focus on financial materiality and its prioritisation of investor needs over those of other stakeholder categories. Consequently, IR adopters have reportedly failed to provide a full and fair disclosure on ESG matters. Such a practice has been fuelled by the primarily financial nature of investors' concerns, which has pushed businesses to focus on the financial implications of material non-financial matters. External assurance provided by auditing firms also represents an attractive avenue to address issues in non-financial disclosure based on the findings of past studies. Several papers indeed suggest that independent assurance is positively associated with the quality of ESG reporting, although non-financial audits are not currently viewed as well-established practices within auditing firms.

The Way Forward: The Main Research Questions of the Project

Extant literature on corporate non-financial and risk disclosure has provided numerous starting points for the development of our research questions. For instance, some studies have suggested performing a content analysis to map the (non-financial) risk categories disclosed in corporate reports. Such an analysis also aims to assess which risk categories receive the highest and lowest degree of coverage in the reports. Additionally, a longitudinal study could be conducted to determine whether a change can be observed in the risks disclosed by corporations and the amount of information provided concerning the different risk types over time. This analysis would take advantage of corporate reports published several years before and after the introduction of the Non-Financial Reporting Directive to gauge its effect on corporate non-financial reporting practices. Furthermore, as risk information has been found to primarily focus on past events, it could be interesting to examine whether an inversion of this trend has occurred in recent years, specifically following the entry into force of Directive 2014/95/EU. Past evidence also indicates that the ESG risk scores developed by rating agencies may not be as accurate and reliable as is typically advertised. Practitioners have indeed expressed concerns over the accuracy of such scores due to subjective trade-offs that are intrinsic in their computation process owing to, for example, the unavailability of comprehensive ESG data and the unpredictability of sustainability risks.

Based on the key insights of previous studies, the following four main research questions (RQs) have been developed:

RQ1: Have the quality and extent of non-financial risk disclosure improved following the introduction of Directive 2014/95/EU?

To provide an answer to this question, we will work on a sample of reports published by listed corporations both before and after the introduction of the Non-Financial Reporting Directive. The analysis will consist of two subsequent phases: firstly, all risk-related sentences found in the reports will be collected by means of a keyword list created on the grounds of applicable regulations;

secondly, each sentence will be evaluated according to a set of dimensions to assess the quality of risk disclosure. Such dimensions include, for instance, the completeness, reliability, and relevance of the disclosed information.

RQ2: What types of ESG risks do corporations address in their reports?

By providing an answer to this question, we aim to develop a taxonomy of the non-financial risks disclosed by corporations in their reports. Risks will be subdivided into different categories based on the topics to which they relate, such as environmental and societal matters, to allow for greater ease of use. The resulting taxonomy will also be benchmarked against the requirements of Directive 2014/95/EU to determine whether companies are addressing all matters deemed relevant based on applicable regulatory provisions.

RQ3: How well do corporations manage their material ESG risks in their operations?

As a part of the outcomes of this project, a practical tool will be developed to assist stakeholders in assessing companies' ESG risk rating. Such a rating aims to evaluate how well a company manages the material ESG risks to which it is exposed in conducting its operations.

RQ4: How are ESG risks interrelated in terms of causes, effects, and management approaches?

To the best of our knowledge, no studies in the academic literature have highlighted the ways in which ESG risks affect and interact with each other. Notwithstanding, given their interconnection, it is necessary to analyse and discuss them in an interrelated manner by underscoring the links among their causes, effects, and management approaches. Along this line, it could be interesting to investigate whether practitioners are drawing such links among their material non-financial risks in corporate reports.