

# The role of non-financial information in early warning and preventive restructuring

Patrizia Riva and Simone Accettura discuss ESG in terms of non-financial information for early warning and preventive restructuring in Italy



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## ESG and the CSRD impact on reporting

The Corporate Sustainability Reporting Directive (**CSRD**) – Directive (EU) 2464/2022, which became effective as of January 2024, made significant changes to the “reporting of corporate information of a non-financial nature”, also called “non-financial reporting”. According to the CSRD, companies will be required to provide forward-looking and retrospective qualitative and quantitative ESG information across the short, medium and long-term time horizons.

The CSRD requires that sustainability information should, as far as possible, cover a company’s entire value chain. Companies required to submit a report will thus be called to provide information with reference also to companies within their production chain, so as to be able to provide disclosure on their value chain. In light of these processes, it is reasonable to believe that supply-chain leading companies will be increasingly requesting sustainability information from SMEs within their supply chain. Although the CSRD does not formally lay down reporting requirements for unlisted SMEs, it should be emphasized that they may also be affected by the new disclosure requirements, as they may be indirectly involved.

The CSRD introduces the principle of mandatory “double materiality”. Companies will be required to consider a double materiality perspective, disclosing the information necessary for an understanding of the impact of

the company’s activities on society and on the environment (“inside-out” perspective) but also the information necessary for an understanding of how sustainability factors influence the company’s development, performance and commercial position (“outside-in” perspective).

ESG information can play a key role in forecasting a crisis because, by being separated from an accounting approach, it is oriented towards the future and therefore has a high predictive value.

## Non-financial information role in early warning

In Italy, the Insolvency and Crisis Code (I-C Code) – which pursued full alignment with the provisions of EU Directive on Restructuring and Insolvency (2019) – introduced the adoption of an approach oriented towards preventive and anticipatory actions before the crisis manifests itself by using a series of reporting and prevention mechanisms companies should be provided with in order to take action before reaching a situation of insolvency or crisis.

In order for this mechanism to work, it seems useful to combine financial indicators with non-financial ESG indicators, which should thus be recognized as having complementary relevance.

The organizational, administrative and accounting structures of the company must be able to allow the entrepreneur to estimate the progress of the company’s activities through the use of key performance indicators

(KPI) and to identify intervention strategies aimed at removing the causes of a crisis.

Organizational structure can be defined as the governance and organizational system strictly speaking, consisting in the setting up of a company’s organization and operating systems. A company’s administrative structure consists of the system of measures, procedures and operating practices adopted by the company to verify whether the conditions of equilibrium of its corporate system have been met by systematically comparing the objectives pursued with the results achieved, and should therefore be able to provide reliable forecasts on the expected future performance of the company’s business operations. A company’s accounting structure consists in the system to be used for the recording of business events aimed at giving a true and fair view of the company’s equity, economic and financial position, and should allow for timely and robust data reporting.

Verifying whether minimum requirements have been met when setting up company’s structures is implicitly necessary as a precondition for the successful performance of a test required by law for all companies to assess their state of health. In particular, the outcome of this test will lead to a measure of time, i.e., it will express the reasonable viability of recovery as a ratio whose numerator is the amount of debt to be restructured and whose denominator is the future free cash flows that company operations on average are capable of generating under normal



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conditions and that can be used to repay such debt in future financial years. The higher the value of the Recovery Time index, the more serious should the company's situation be considered.

Once it has been assessed that the company is likely to suffer a crisis, the I-C Code requires a plan to be drafted. To this end, the company will be required to carry out a self-assessment by using a checklist. This consists of a series of questions that will be useful for the company's directors and managers to reflect on the design and robustness of the company's organizational, accounting and administrative structure as implemented and on any weaknesses that need to be remedied.

The measures and the structure in question should make possible the detection of a series of appropriately identified signals, and thus indicators, to be used by the company as parameters to understand situations of potential decline, or actual crises, in order to activate the resulting reporting and early-warning systems and define the most effective operating actions.

### ESG factors as useful elements for forecasting business crisis

It is not easy to identify ESG indicators suitable for representing the business outlook of a company. To do this, it is necessary to have timely and complete knowledge of business and management events, being able to identify the critical success factors to be taken into consideration. OIBR, the Italian Business Reporting Organization which represents the Italian jurisdiction within the global network WICI, has published a document entitled "*Non-financial information for adequate structures and crisis forecasting in SMEs*" (2022). This document defines a methodological approach and a reference model for the identification of non-financial ESG indicators that may be used to verify whether a

company's operating structure is adequate and promptly predict crises. As a result of its analyses, the document proposes a matrix containing a selection of indicators for each of the corporate dimensions covered, divided into dimensions relating to the description of an adequate corporate structure and dimensions used for crisis-forecasting.

The adequacy of a company's corporate structure should be assessed and pursued by adopting an approach based on the principle of proportionality, which takes into account the size of the company, the characteristics of the business activity being carried out and any applicable regulatory obligations. At the same time, the company's corporate structure will be adequate when it allows the company to gain the information necessary to comply with regulatory provisions and, more generally, to identify critical success factors and to promptly detect signs of crisis.

The creation of indicators based exclusively on data from accounting records may result in misleading assessments regarding the going-concern assumption, as such data does not take into consideration non-accounting circumstances that may come about in the future or the various risks to which the company may be exposed. These include:

- a) environmental risk, which depends on external phenomena outside of the company's control,
- b) reputation risk, relating to the image that the external environment has of the company,
- c) strategic risk, related to various variables with strategic value,
- d) organizational risk, connected to potential errors in the design of the company's corporate structure, and
- e) market risk, deriving from unfavourable conditions on the target market.

On the one hand, ESG factors can therefore represent a useful element for forecasting a business

crisis. In the Italian context, the regulatory paradigm laid down in the Insolvency and Crisis Code highlights these aspects, as extreme importance is given to the establishment and description of an adequate corporate structure.

On the other hand, ESG factors may constitute issues leading to a business crisis, unless adequately addressed and managed. In conclusion, it becomes essential to integrate the management, planning and reporting dashboard with material ESG non-financial information. ■

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