ECCJ briefing
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Assessment of the EU Directive on the disclosure of non-financial information by certain large companies

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On 15 April 2014 the European Parliament ratified the Directive on non-financial reporting. Its vote in the Council will follow shortly and after a legal-linguistic verification the final adoption is expected in September or October 2014. Twenty days later it will be published in the Official Journal of the EU and enter into force. Member States will then have 2 years to transpose it into their national legislation.

The new Directive marks a significant step. It will require large listed companies to report annually on principal risks to human rights, the environmental and social impacts linked to their operations, relationships, products and services – as well as aspects related to bribery and diversity – and their due diligence procedures for identifying, preventing and mitigating those risks. The reform recognises that such risks must be disclosed regardless of what a company considers being relevant, i.e. material, to the interests of its shareholders, which was the organising principle of the accounting law until now. This legislation is the first step in embedding into EU law the corporate responsibility to respect human rights and the environment as it is expressed in the UN Guiding Principles and OECD Guidelines for Multinational Enterprises.

I. Summary of the content of new reporting Requirements

The Directive will require "public interest entities"[1] with more than 500 employees (on a consolidated basis in case the company is parent undertaking of a large group) to provide an annual non-financial statement regarding information relating to at least human rights, environmental and social matters[2]. This information shall allow for an understanding of the undertaking's development, performance and position and of the impact of its activity on society.

The information provided must include a description of the entity's policies in relation to these matters, including any due diligence procedures that it implements to identify, prevent and mitigate its existing and potential impacts, and the outcomes of those policies. It must also include a description of the principal risks[3] of the entity's business in relation to each of these matters and how it manages those risks. With respect to due diligence procedures and risks, the entity must report on both its own operations and, when relevant and proportionate, its supply chains and business relationships. The company shall also provide a brief description of its business model.

[1] Public interest entities (PIE) are listed companies, credit institutions, insurance undertakings and any other entity designated by an EU member state as a PIE (for example because they are of significant public relevance due to the nature of their business or size).
[2] Recitals specify that the "statement should contain, as regards environmental matters, details of the current and foreseeable impacts of the undertaking's operations on the environment, and, as appropriate, health and safety, the use of renewable and/or non-renewable energy, greenhouse gas emissions, water use and air pollution. As regards social and employee-related matters, the information provided in the statement may concern the actions taken to ensure gender equality, implementation of fundamental conventions of the International Labour Organisation, working conditions, social dialogue, respect for the right of workers to be informed and consulted, respect for trade union rights, health and safety at work and the dialogue with local communities, and/or the actions taken to ensure the protection and the development of those communities. With regard to human rights, anti-corruption and bribery, the non-financial statement could include information on the prevention of human rights abuses and/or on instruments in place to fight corruption and bribery".
[3] Defined in the recitals as "matters that stand out as being most likely to bring about the materialisation of principal risks of severe impacts, along with those that have already materialised. The severity of such impacts should be judged by their scale and gravity".

Reporting is mandatory, yet flexibility is given to companies by the "comply or explain" approach. If a company does not pursue policies in any of the areas, it must provide a clear and reasoned explanation for not doing so. Thus, this does not free a company from the obligation to identify and disclose principal risks.

However, the Directive does provide an "emergency exit" clause ("safe harbour"): in exceptional cases, Member States' laws implementing the Directive may allow companies to hold back the disclosure of information relating to impending developments or matters in the course of negotiation if such disclosure would be seriously prejudicial to the entity's commercial interest. Companies' directors would have collective responsibility to ensure that such omission is not misleading.

The Directive references various standards that companies can rely on in their reporting, including the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises[4]. Yet any national, EU or international framework can be used. The Directive does not prescribe the use of common, specific indicators which would have ensured a minimal level of comparability as regards, above all, of measurable environmental impacts.

The task of auditors will be limited to verifying whether the non-financial statement or a separate report has been provided. It is up to Member States to decide whether to implement more rigorous verification methods or not, such as a verification by an independent assurance service provider.

Member States may allow the company to provide a separate report, rather than integrating the non-financial statement in the management report, as long as the separate report is either published together with the management report or is made public on the undertaking's website within 6 months of the balance-sheet date – 2 months later than the management report. This approach, unfortunately though, is out of step with the growing trend toward integration of financial and non-financial reporting.

The monitoring and enforcement of the obligations is very much left to Member States that are responsible for putting in place effective procedures to enforce compliance. The general requirements applicable to the management report also apply to the non-financial statement: Member States shall ensure that members of the administrative, management and supervisory bodies have collective responsibility for drawing up and publishing the non-financial report in accordance with requirements; moreover, laws, regulations and administrative provisions on liability should apply in case duties are breached. Recitals add that Member States should ensure that those procedures are available to all persons and legal entities having a legitimate interest in ensuring that the provisions are respected.

The Commission has been mandated to publish within two years non-binding guidelines on methodology, including general and sectorial non-financial key performance indicators – covering at least land use, water use, greenhouse gas emissions and use of materials. This process should ideally be developed through appropriate consultations with stakeholders.

The Directive will be reviewed at the latest four years after it enters into force. The report to be submitted by the Commission on the implementation of the Directive shall include among other aspects its scope – particularly as regards large non-listed companies – and its effectiveness.

II. Major shortcomings

The Directive sets the right principles, in particular by redefining the materiality test – companies must disclose information that is relevant for an understanding of the impacts of their activity – and by embedding the concept of (human rights) due diligence. However, the Directive does not provide clear instructions as to the reporting on risks and impacts throughout a company's operations. Through the development of reporting standards the following issues must be specified:

[4] Full list provided in the recitals include EMAS, UN Global Compact, ISO 26000, ILO Tripartite Declaration, GRI and "other recognised international frameworks"

- There is only an implicit requirement to report on ongoing impacts and incidents, which is of particular importance in business and human rights conflicts, and criteria for determination of “principal risks” are not sufficiently specified.
- Reporting on risks from supply chains and business relationships is required “if relevant and proportionate” without further specification. This could lead to diverging interpretations.
- Companies are encouraged to report in accordance with international standards of their choice. However these standards differ significantly in their purpose, content and definitions.

The legislation applies only to a limited number of large EU companies. The European Commission originally proposed that the Directive apply to 18,000 companies – listed and non-listed - that had over 500 employees and a certain annual turnover or balance sheet total. The adopted scope covers about 6,000 of the 42,000 large companies that are incorporated within the European Union.

Finally, there is a real risk that the safe harbour clause, if the rules for its application are not clarified by States, would render non-financial reporting requirements meaningless.

III. Impact of the new Directive

This reform is a first significant step towards making business accountable to society, and a major success for the corporate accountability movement in Europe. The legislation is not perfect, as outlined above, but it open the door for changes in the ground and for further legislative developments.

This reform will enhance the transparency of European business

Disclosure of human rights, social and environmental risks becomes mandatory for some of the largest EU companies. This legislation - which follows another important reform on tax transparency[5] - shows that EU decision makers are finally hearing the calls for greater transparency and accountability from by civil society.

The reform shifts the rationale of corporate reporting and sends a strong signal: society expects that companies must place human rights and environmental issues alongside financial performance. Businesses should not be transparent because it’s good for their reputation, demanded by their shareholders or material to their performance, but because their impacts are of key concern to its stakeholders and society as a whole.

For companies, publicly acknowledging the problems is a first step to start addressing them. By complying with the new requirements, companies will have a better understanding of the risks they face, and will be pressured internally and externally to act to reduce these risks. Even if the requirements apply to a relatively small number of companies, these are among the national, European and sometimes global leaders in their sectors. Their strengthened disclosure practices have the potential to drive the whole sector towards greater transparency.

Access to non-financial information by workers, communities, consumers is essential in order to hold companies accountable for negative impacts. Those affected by business operations will better assert their rights and fulfil their roles, as more robust reports will enable them to better assess the scope and impacts of companies operations on society and to monitor their progress.

The directive will empower NGOs to pressure national authorities to properly enforce new requirements, in the beginning at least in cases of flagrant omissions. It will also provide ground to argue that authorities should start requiring companies to meet material standards where they do business with them. Similarly, the (lack of) information on a company's due diligence can be used by victims of corporate misconduct to argue in judicial and similar procedures that a company in question was negligent and thus liable for the harm. In this respect, this new transparency requirement can speed up the implementation of human rights due diligence concept in the tort law concept of duty of care.

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5 In 2013 the EU adopted a legislation on mandatory “country-by-country and project-by-project reporting” on tax, profits, revenues and staff number by large companies in the extractive and logging sectors

The directive lays down a procedure for future improvements. The issue will remain on the political agenda through the development of guidance within 2 years and a revision of the Directive after 4 years.

This reform creates precedents for future policy developments on CSR and corporate accountability

Several important elements in the final text represent significant improvements in the wider debate on corporate accountability. The EU is slowly moving away from an era of "laissez-faire". A few years ago the Commission was still rejecting any legislative intervention in the area of CSR – now the discourse that first changed in 2011 in the new CSR Communication is finally matched with concrete legislative action.

The NFR Directive builds on the language of the UN Guiding Principles on Business and Human Rights and embeds the concept of (human rights) due diligence in legislation. By including a reference to business relationships, the EU further recognises that companies are expected to address their risks and impacts linked to their operations outside Europe.

IV. Priorities and next steps to ensure effective implementation by States and companies

A Directive is quite a flexible instrument. It obliges Member States to achieve a specific result but leaves them a certain level of flexibility in the way they will transpose and implement these requirements into internal law – including the possibility to go beyond the minimal requirements.

Some provisions are optional and will be maintained or dropped in the transposition in national law. It includes the "safe harbour clause", the possibility for the company to provide a separate report rather than integrating the non-financial statement in the management report, and the verification by an independent assurance services provider.

When implementing the Directive into national law, Member States will have the opportunity to proof their commitment against corporate human rights and environmental abuses, by strengthening the EU requirements, by not making use of the proposed exemptions and by supporting the development of guidelines by the Commission which should clarify the responsibilities and expectations of companies under the Directive.