Chapter 14
Sustainability reporting and the modernisation of EU accounting rules

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1. Introduction

Companies and other types of organisations are facing increasing public pressure to act in a socially and ecologically responsible manner. Effects upon society and the environment have become a key part of assessing the overall success of an organisation and its capacity for sustainable functioning. This is a consequence of growing awareness of the need to assure healthy ecosystems, social equality and good management of organisations. The sustainability performance of companies is increasingly being monitored by non-governmental organisations (NGOs), rating agencies and other organisations. Consequently, a widely-held view is that business entities must go beyond bare financial reporting and disclose comprehensive and credible information on a variety of environmental and social indicators. There is also a significant demand by investors for non-financial information on companies to measure and control the 'reputational risk' they face when investing in companies with poor environmental and social practices.

The revision of accounting standards is a core component of the reforms at the EU and global level[1] responding to the current economic crisis with the aim of increasing transparency and market confidence. This is also an opportunity to push for a stronger role for sustainability reporting, as in the context of a crisis companies often tend to pay less attention to social and environmental standards. In this respect more specific rules are needed. This is most notably the case for reporting on social and organisational restructuring, which has made considerably less progress than environmental reporting in the last decade, notwithstanding

1. Most notably the initiatives of the Financial Stability Board.

the fact that employees are the key stakeholder group in companies. The economic crisis should therefore be used to establish stronger standards for socially responsible reporting. Such standards are necessary in order to enable the monitoring of companies and their progress towards sustainability.[2]

This chapter deals with legal aspects of sustainability reporting in the EU. It explores, first, the state of affairs in sustainability reporting regulation and points out recent increased support for integrated reporting. Second, EU rules in this field are discussed, starting with rules on financial reporting. This is important as developments in this field offer several lessons for future regulation of non-financial reporting. Furthermore, it is anticipated that financial and non-financial reporting will be integrated in the future. In relation to non-financial reporting, the current state of affairs is presented and open questions and legal alternatives for more effective and worker-oriented regulation are discussed.

2. From non-financial to integrated reporting

2.1 General observations

For many years, annual reports were documents in which companies presented their financial results, recent achievements and vision for the future. Recently, however, among various groups interest in environmental, social and ethical achievements of companies has grown significantly. For this reason, companies increasingly include corporate responsibility matters in such reports. The underlying rationale is that financial accounts can only partially indicate both the risks and potential value of the company which derive from intangible factors, such as environmental and social risks, strategies, product innovativeness, trademarks, reputation, energy effectiveness, etc.

Non-financial reporting, also known as sustainability reporting,[3] enables companies to disclose such non-financial aspects of their business activities. Sustainability reporting thus refers to the practice of measuring and

2. On the importance of sustainability reporting for realising the Sustainable Company see chapter 1 of Vitols and Kluge (2011).
3. Other terms in use include: corporate social responsibility (CSR) reporting, environmental social governance (ESG) reporting and triple bottom line (TBL) reporting.

disclosing as well as informing internal and external interest groups on progress towards the goal of sustainable development and social responsibility (in other words, *corporate social responsibility* (CSR)) (Ernst & Young 2009). The latter stands for predominantly voluntary commitments by companies to act ethically and to contribute to economic development in parallel with improving the quality of life for employees and their families, while at the same time helping the local and wider community.[4] The goal of socially responsible companies is therefore to contribute to improving society and creating a cleaner environment.

Many companies use non-financial reporting to improve their societal reputation. This form of transparency makes these companies appear more responsible and thus less risky to investors. This means that the main advantage of non-financial reporting is the transparency of the companies that disclose non-financial information. It improves competitive advantage and reputation and enhances the capacity to satisfy workers, shareholders and customers. It improves the quality of information available to employees. Investors have more reliable information for the comprehensive evaluation of companies. This, in turn, increases the trust of investors and leads to a better allocation of capital. It also increases trust of owners, donors, sponsors and financial institutions and assists branding. Consequently, non-financial reporting increases long-term competitiveness, facilitates access to capital and reduces reputational risks. Better disclosure of non-financial information enhances the image of an accountable enterprise. Furthermore it encourages positive relationships with other companies, public authorities, media, suppliers, the community in which the company works, as well as to the environment, as it may lead to increased sustainability. For example, Business in the Community, a British business-community charity promoting responsible business, has conducted research which reveals a significant link between effective management and governance of environmental and social issues and financial performance.[5] The results revealed that those companies which actively managed and measured social and environmental issues outperformed their FTSE 350 peers on total shareholder return by between 3.3% and 7.7% (Laboratory on Valuing Non-Financial Performance 2008). For all these reasons, despite the

4. For a definition see World Business Council for Sustainable Development (2000).
5. The report examines the relationship between total shareholder return, dividend yield and share volatility and the management of non-financial issues in the 33 UK companies listed on the London Stock Exchange and included in the FTSE 350 index.

predominantly voluntary nature of sustainability reporting, most large multinationals listed on stock exchanges provide environmental and social information in some form.

Increasingly, non-financial reporting is affecting annual reports, since many of these annual reports include more information on CSR initiatives. Furthermore, many companies issue separate reports on social responsibility. The manner in which annual reports are published is also changing. Due to the importance of social responsibility initiatives for strengthening public image, companies are making efforts to make sure that annual reports, including information on social responsibility, reach consumers and investors. For this reason, companies use various media, including social networks such as Facebook and Twitter, to publicise the results contained in their annual reports. The reports increasingly include statements of reliability given to the reports by independent external sources with the aim of increasing the level of trust in the disclosed information. Development of CSR thus considerably influences accounting practices in general. In this respect the main challenge for the future is to develop measurable frameworks for sustainability reporting, harmonisation of definitions and more comparable use of such reports. The way to achieve it is to bring the national and supranational legislation and other rules in the field closer together.[7]

2.2 International standards on non-financial reporting

Despite its predominantly voluntary character, non-financial reporting is not totally devoid of legal provisions. At the global level a series of actors have developed individual principles and standards for non-financial reporting – e.g. Global Reporting Initiative (GRI), UN Global Compact, the ISO 26000 standard developed by the International Organization for Standardization, Organisation for Economic Co-operation and Development (OECD) guidelines, International Labour Organisation (ILO) conventions, International Accounting Standards Board (IASB) commen-

6. See the Methodologie (2011: 2) which serves as a barometer of modern reporting practices.
7. Synchronisation of voluntary standards on non-financial reporting with compulsory national and supranational requirements is supported by the recent initiative of the Global Reporting Initiative and the World Intellectual Capital Initiative to develop extensible business reporting language (XBRL) taxonomies for non-financial information. The importance of XBRL is underlined by the fact that the US Securities and Exchange Commission now requires financial reports to be filed in XBRL format.

tary, and initiatives of the Financial Stability Board (FSB) established by the G20 group. None of these is currently truly globally accepted in the same way as financial reporting standards are. None the less, GRI standards come very close to this and are, for this reason, presented in more detail.[8]

GRI develops standards of sustainability reporting that are widely used across the globe.[9] GRI was established in 1997 by the Coalition of environmentally responsible economies (Ceres) with the assistance of the environmental programme of the United Nations. In 1999, GRI published a draft version of *Sustainability Reporting Guidelines* and in 2000 the first complete version was published. GRI is a permanent institution of international law with a secretariat in Amsterdam. It is independent even though it cooperates with the environmental programme of the UN and with the initiative UN Global Compact.

GRI aims to ensure that, in the long term, sustainability reporting will become a regular feature of organisational behaviour in the same way as financial reporting has already become. Its standards are used by all kinds of organisation, including large corporations, public companies, small companies and non-governmental organisations. GRI standards constitute a framework for reporting on issues such as human rights, position of workers, environment, corruption, etc. They are considered the most credible of the international standards as they have been developed through a consensus-seeking, multi-stakeholder process. Participants in that process are drawn from global business, civil society, labour, academic and professional institutions.

GRI is seeking to gradually improve standards of sustainability reporting. Today the third generation of GRI standards (GRI-G3), published in October 2006, is in force. GRI-G3 standards include both principles and items, with the latter composed of several performance indicators. The principles of sustainability reporting help to define:

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8. See also Expert Group on Disclosure of Non-Financial information by EU Companies (2011a).
9. In 2009, over 1 400 organisations from 60 states used their standards when preparing sustainability reports and eleven states referred to GRI standards in their national rules – see Global Reporting Initiative (2009/10). According to the GRI database, in 2010 sustainability reports were produced by nearly 2 000 companies - Sustainability Disclosure Database, <http://database.globalreporting.org/search> (8.1.2012). Additionally, international research shows that sustainable reporting is considerably better developed in Europe than in the USA – e.g. in 2010 only 251 companies from North America produced sustainability reports in contrast to 843 European companies.

a) report content: principles of materiality, stakeholder inclusiveness, sustainability context, and completeness;
b) report quality: principles of balance, comparability, accuracy, timeliness, reliability, and clarity; and
c) report boundary: in preparing a sustainability report, a reporting organisation needs to set a 'boundary' that defines which entities are included in a report (e.g. parent company and its subsidiaries), and which are excluded (e.g. joint ventures) (Global Reporting Initiative 2005).

Performance indicators for sustainability reporting require disclosure of specific aspects. Items for reporting relate to matters such as:

- environment: materials, water, biodiversity, emissions, etc.
- human rights: clauses incorporating human rights concerns in investment and public procurement contracts, the prohibition of discrimination, freedom of association and collective bargaining, child labour, forced labour, etc.
- decent work: statistics on employees – total workforce by employment type, employment contract, region, gender, return to work and retention after parental leave, number of employees covered by collective bargaining, safety at work, education and training, equal pay for equal work, etc.
- society: impact of the business on the local community, corruption, compliance with competition and other regulatory legislation, etc.
- product responsibility: consumer protection, labelling, etc.

GRI-G3 standards are the basis for sustainability reporting. Other components of the framework include sector supplements (specific indicators for a particular industry) and national annexes (information specific to a particular country). The whole reporting framework (including GRI-G3 standards) is a free public good. It is worth mentioning that the fourth generation of sustainability reporting standards is currently being prepared (GRI-G4), with publication envisaged in 2013.[10]

10. Given that the new generation of standards is also being developed by way of international consultations and workshops involving a broad spectrum of interest groups, GRI has appealed to interested stakeholders to cooperate.

2.3 Integrated reporting

Following the outbreak of the current financial crisis certain initiatives promoting integrated reporting have been developed. For example, the Prince of Wales' Accounting for Sustainability project produced a linked reporting framework in 2007. The aim of the project was to produce a series of case studies that document the ways in which connecting financial and sustainability information can improve organisational processes and actions.[11] As the crisis has demonstrated the need for capital market decision making to reflect long-term considerations, the project began to collaborate with the International Federation of Accountants (IFAC) and the GRI with a view to establishing an International Integrated Reporting Committee (IIRC), recently renamed the International Integrated Reporting Council.

The role of the IIRC, which was established in August 2010, is to help develop a new internationally accepted approach to reporting. The result of this process will be reports that not only provide financial information, but information about an organisation's governance, social and environmental performance in an integrated manner, reflecting the fact that all these elements (financial, governance, social and environmental) are closely related and interdependent.[12] As the IIRC explains:

> Integrated reporting demonstrates the linkages between an organisation's strategy, governance and financial performance and the social, environmental and economic context within which it operates…Integrated reporting can help business to take more sustainable decisions and enable investors and other stakeholders to understand how an organisation is really performing (IIRC 2011b).

An integrated report should be a single report which is the organisation's primary report – in most jurisdictions this will be the annual report or

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11. The Prince's Accounting for Sustainability Project, Accounting for Sustainability: Practical Insights Book, <http://www.accountingforsustainability.org/embedding-sustainability/accounting-for-sustainability-practical-insights-book> (8.1.2012). Companies reporting using this framework, which links sustainability performance reporting with financial reporting and strategic direction in a connected way, include Aviva, BT and HSBC (see Hopwood *et al.* 2010).
12. The IIRC published an Integrated Reporting Discussion Paper for public consultation in mid-2011 and launched a pilot programme for integrated reporting in October 2011 (IIRC 2011a).

equivalent. By addressing the material issues for an organisation, an integrated report should demonstrate in a clear and concise manner an organisation's ability to create and sustain value in the short, medium and longer term.[13]

In light of the increasing emphasis on sustainable development and the lessons learned in the last economic crisis, it is reasonable to expect that integrated reporting will prove an important goal for organisations as they face up to the challenges of the 21st century. In this respect, the EU should lead the way, adopting clear and effective rules, which will assure reliable integrated reports, and encouraging its trade partners to adopt comparable rules.

3. Regulating corporate reporting in the EU

This section begins with an overview of the regulation of financial reporting in the EU before turning to existing initiatives and rules already adopted on sustainability reporting.

3.1 Overview of the regulations on financial reporting

Accountancy is the business discipline of collecting and analysing critical financial information about a business entity that is relevant for internal decision making (also known as management accounting) as well as for external entities, such as shareholders, creditors, financial analysts and government agencies (also known as financial accounting) (Eliot and Eliot 2004: 3). The latter is much more structured than the former as it needs to respond to various needs of the users outside the business entity and is therefore subject to different accounting principles at national, regional and international level. The need for reliable financial statements was accentuated after the 2001 series of financial informa-

13. Corporate reporting on financial and non-financial information in a single document has grown as socially responsible investing (SRI) has grown faster than the investment industry overall. As more assets are managed within SRI frameworks, more investors are going beyond financial information to consider non-financial, extra-financial or environmental, social and governance (ESG) information in investment decisions. Companies that already produce integrated reports include BASF, Philips, Novo Nordisk and United Technologies Corporation.

tion frauds involving Enron Corporation and some other well-known corporations, in which management manipulated the figures shown in financial reports to suggest better economic performance than was the case. These problems highlighted the need to review the effectiveness of accounting standards, auditing regulations and corporate governance principles. The Enron scandal has led to the development of new regulations to improve the reliability of financial reporting across the globe, including the EU.

The accountancy framework of the EU was adopted more than thirty years ago. In 1978 the Council adopted the Fourth company law directive on the annual accounts of companies (Council of the European Union 1978). In 1983 the second important accountancy directive followed – the Seventh company law directive on consolidated accounts (Council of the European Union 1983).[14] These directives regulate issues concerning the formation, adoption and publication of (consolidated) annual accounts. They have increased the quality of accounting reporting and enabled comparability and mutual recognition of reports across the EU.[15] Nonetheless, from the early 1990s this accounting law framework started to cause increasing problems for corporations within the EU seeking to raise capital on international markets. Existing accountancy directives did not ensure the comparability of the accounts of public companies at international level, which proved to be detrimental to the holders of corporate securities and, in addition, prevented effective control of financial reporting. These disadvantages reflected the fact that the aim of the directives (in accordance with the nature of directives) was simply to harmonise accounting regulations of the Member States and not to achieve complete standardisation of accounting rules. Financial reports drafted on the basis of the directives and the relevant national implementing legislation did not fulfil international (above all US) legal requirements in the field. As a result, large European companies (global players) seeking to participate on international capital markets (in particular the New York Stock Exchange) needed to produce two sets of accounts. This was not only expensive but also led to confusion, both within the companies and on capital markets, as it was often the case that reports on the same company showed both a profit and a loss, depending on the accountancy rules applied in preparing the report.

14. See also Council of the European Union 1986, 1991.
15. It is also worth mentioning Council of the European Union 1984.

In order to assist large European companies, the Commission issued a new accounting strategy in 1995 (European Commission 1995) with the objective of developing accounting standards recognised on all world capital markets. In this respect, the Commission proposed that the new approach should be oriented towards the International Accounting Standards (IAS),[16] which present an 'exhaustive and conceptually strong set of reporting standards that are intended for the business public'.[17] IAS have been adopted by the International Accounting Standards Committee in London for over thirty years.[18] Since 1983 the Committee has comprised professional accounting organisations that are members of the International Accounting Association. This institutional backing ensures that the IAS have the status of well-devised and internationally recognised accounting standards. Moreover, these also enjoy the recognition of the International Organisation of Securities Commissions (IOSCO). On the basis of this strategy, the Commission adopted a proposal in 2001 for a regulation on the application of international accounting standards (European Commission 2001a). In its proposal, the Commission explained that the internal market approach to accounting in the EU is based on the political goal of establishing complete and effective capital markets. In its analysis, minimum requirements on financial reporting were no longer sufficient and measures to achieve 'considerably higher level of comparability of business accounts across the internal market' (ibid.) were needed. On the basis of this proposal, Regulation No 1606/2002 on the application of international accounting standards was adopted (European Parliament and the Council of the European Union 2002). It is one of the most important instruments of EU accounting law and serves as a basis for the endorsement and application of the International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS)[19] in the EU (Article 1 of Regulation

16. It is interesting to note that the Commission did not consider the possibility of adopting US standards (US GAAP). The reason for this was that the US standards had been established for the US market only. The possibility of a political dimension to this decision cannot be disregarded, given that – in contrast to the IAS – the EU did not have a say in establishing US GAAP.
17. See European Commission, http://ec.europa.eu/internal_market/accounting/index_en.htm.
18. The structure of the Committee was changed in April 2001 and it was replaced by the IAS Board.
19. IFRS are issued by the International Accounting Standards Board (IASB). IAS were issued by the IASC, predecessor of IASB until 2000. As many of the standards forming part of IFRS are known by the older name of IAS, the latter term is used in this chapter. In a similar vein, Regulation No 1606/2002 is commonly known as the IAS Regulation.

No 1606/2002). The Regulation provides that 'for each financial year starting on or after 1 January 2005, companies governed by the law of a Member State shall prepare their consolidated accounts in conformity with the international accounting standards adopted in accordance with the (special endorsement) procedure … if, at their balance sheet date, their securities are admitted to trading on a regulated market of any Member State …' (Article 4).

Table 1 **Application of IAS by EU companies**

	Consolidated accounts	Annual reports
Public limited companies	Obliged to use IAS	Member States may apply* IAS
Other limited companies	Member States may apply* IAS	Member States may apply* IAS

Note: * Member States may *permit or require* application of IAS.

The Regulation also served as the legal basis for the establishment of a special Accounting Regulatory Committee. The Committee is composed of the national representatives of the Member States under the presidency of the Commission. The purpose of the Committee is to give opinions on Commission proposals to endorse IAS. The latter cannot apply directly in the EU,[20] as the EU cannot authorise a private law organisation, over which it has no direct influence, to form standards binding in the EU (European Union 2001). For that reason a special endorsement mechanism was needed, in accordance with which the Commission drafts a proposal to endorse one or more IAS for the purposes of EU law. The Committee either approves or rejects that endorsement. This mechanism ensures that within the EU only such IAS apply as do not contravene EU policy, and, at the same time, increases legal certainty, as specific regulations clearly indicate which IAS bind European companies.

Notwithstanding the adoption of the Regulation on IAS, the EU accounting directives remain in force. They are binding for a large group of business entities that are not bound by the Regulation on IAS. In order to ensure equal treatment (in other words, a level playing field) for the en-

20. IAS normally do not directly apply; their compulsory nature is recognised only in some states, including Croatia, Macedonia, Serbia, Armenia, Cyprus, Estonia and a few others.

tities that are subject to IAS and those that continue to apply national accounting provisions, the Commission adopted proposals to amend the existing accounting directives (e.g. the principle of prudence was replaced by the fair value principle). Additional amendments were also needed for reasons of general developments in the accountancy profession resulting from technological change (e.g. recognition and valuation of intangible assets). The first important amendment of the accounting directives was introduced by Directive 2001/65/EC, which changed the valuation rules (European Parliament and the Council of the European Union 2001). Other amendments were adopted in the directive revising certain accounting thresholds (Council of the European Union 2003). A third group of amendments were introduced by Directive 2003/51/EC (known as the Modernisation Directive) (European Parliament and the Council of the European Union 2003), which concluded the harmonisation of the accounting directives with IAS. In addition, as a measure to cut administrative costs, as identified in the Commission's action programme (European Commission 2007), Directive 2009/49/EC was adopted to allow Member States to exempt medium-sized entities, which often focus on only one business activity, from unnecessary obligations to disclose certain information in the notes to the annual accounts (European Parliament and the Council of the European Union 2009).

When the current financial crisis escalated, numerous international accounting rules were severely criticised. Consequently, at present the Commission is endeavouring to achieve a global agreement on a single system of accounting standards ensuring greater financial transparency. This is in line with the latest publication of stricter requirements for disclosure of risk related to financial instruments by the International Accounting Standards Board (IASB). In addition, it is also planned to adopt stricter requirements in relation to disclosure of off-balance sheet items. Furthermore, the Commission recently proposed the simplification of accounting rules for small and medium-sized enterprises (SMEs) and reducing burdensome reporting obligations for listed companies, including SMEs, adding further to cost savings (European Commission 2011a; see also European Union 2011).

3.2 Regulating non-financial reporting

As regards regulation on non-financial reporting, the achievements of EU are considerably more modest.

Recommendation on disclosure of environmental issues

The EU's commitment to sustainability reporting was first demonstrated in 1992, when the Commission published its fifth action programme on the environment *Towards sustainability* (European Commission 1992). Among a range of proposals in the area of environmental protection, it provides for a Community initiative in the area of accounting. Following amendments introduced by the 1997 Treaty of Amsterdam, a new provision was inserted in the EC Treaty. This acknowledges that a key element for promoting sustainable development is the principle that environmental protection requirements must be integrated into other policies (now Article 11 of the Treaty on the Functioning of the European Union (TFEU)). This was supplemented in 2001 by a Commission communication concerning the Sixth action plan for the environment (European Commission 2001b). Notwithstanding those measures, the Commission observed in the same year that:

> the lack of explicit rules has contributed to a situation where different stakeholders, including regulatory authorities, investors, financial analysts and the public in general may consider the environmental information disclosed by companies to be either inadequate or unreliable. Investors need to know how companies deal with environmental issues. Regulatory authorities have an interest in monitoring the application of environmental regulations and the associated costs. Nonetheless, voluntary disclosure of environmental data in the annual accounts and annual reports of companies is still running at low levels, even though it is often perceived that enterprises face increasing environmental costs for pollution prevention and clean-up equipment and for waste clean-up and monitoring systems, in particular those enterprises operating in sectors that have significant impacts on the environment (European Commission 2001c: 33).

The first step in resolving those problems was the adoption on 30 May 2001 of a Recommendation on the recognition, measurement and disclosure of environmental issues in the annual accounts and reports of companies (*ibid.*). The Recommendation clarifies the accounting rules and indicates how the quality, transparency and comparability of environmental data given in companies' annual accounts and annual reports can be improved. It states that the absence of a common set of rules for disclosing matters relating to the environment in financial information makes it very difficult to make valid comparisons between companies. The Recommendation encourages companies to improve the environmental information provided to the regulatory authorities, investors, financial analysts and the public in general. In that regard, it encourages Member States to ensure that companies covered by the Fourth and Seventh Company Law Directives and banks and insurance companies observe its provisions. As the recommendation is not binding (Article 288 TFEU), its practical effect is dependent upon the persuasive power of the Commission, which called for the Member States to take account of the recommendation and report to the Commission on the measures taken in this respect.

EU accounting directives

Following the adoption of the Modernisation Directive in 2003, non-financial reporting has also become the subject of EU legislation. It is now addressed in the Fourth Company Law Directive as amended. Article 46(1)(b) of the modernised directive provides that, to the extent necessary for an understanding of the company's development, performance or position, the analysis in the annual report shall include both financial and, where appropriate, non-financial key performance indicators relevant to the particular business, including information relating to environmental and employee matters. A similar provision to that set out in Article 46 of the Fourth Directive is now also included in Article 36(1) of the Seventh Company Law Directive, which regulates the content of consolidated annual reports. Their importance is further emphasised in the Transparency Directive, which in Article 4(5) provides that '(t)he management report shall be drawn up in accordance with Article 46 of Directive 78/660/EEC and, if the issuer is required to prepare consolidated accounts, in accordance with Article 36 of Directive 83/349/EEC' (European Parliament and the Council of the European Union 2004: 45).

In comparison with the provisions on financial reporting, which are very precise and comprehensive, provisions on non-financial reporting can be considered, at best, modest. Considering the importance of sustainable development and CSR for the future development of the European economy and society, the present EU regulation on non-financial reporting cannot be perceived as satisfactory as it lacks sufficient legal obligation. Non-financial reporting is voluntary as the directives support it only 'to the extent necessary'. According to respondents to the Commission's public consultation (European Commission 2011b), this makes it difficult for shareholders and investors to make reasonable assessments of CSR-related activities. Some even stated that the voluntary regime is simply a means of enhancing company reputation and inadequate as a mechanism to ensure the greater objectives of CSR reporting. In this respect, the ETUC recently emphasised that 'it is not enough to "invite" companies to act responsibly; more concrete/binding measures are needed' (ETUC 2011: para. 17).

A further problem is that there are considerable differences in the treatment of companies across the EU. As directives are harmonisation instruments not designed to establish uniform rules, certain Member States (United Kingdom, France, Netherlands, Sweden and Denmark) have adopted provisions that exceed the requirements established in the directives – e.g. Denmark has adopted the UN Global Compact as a reference, whereas the French law developed a national frame of reference. Furthermore, while some Member States provide for compulsory non-financial reporting, others adopted the 'comply or explain' system. This situation hinders the single market and creates difficulties in benchmarking between companies in different jurisdictions. Moreover, Member States may exempt small and medium-sized companies from the obligation of reporting on these matters, which additionally diminishes the importance of non-financial reporting.

Given that the provisions on sustainability reporting were only recently introduced into the accounting directives (that is, in 2005, when the importance of CSR was already widely acknowledged), it is surprising that the matter has not been regulated in more detail. The reasons for the voluntary approach of the Commission may be found in the preamble to Directive 2003/51/EC, which states in recital 9 that:

> The annual report and the consolidated annual report are important elements of financial reporting. … The information should not be restricted to the financial aspects of the company's business. It is expected that, where appropriate, this should lead to an analysis of environmental and social aspects necessary for an understanding of the company's development, performance or position. … However, taking into account the evolving nature of this area of financial reporting and having regard to the potential burden placed on undertakings below certain sizes, Member States may choose to waive the obligation to provide non-financial information in the case of the annual report of such undertakings.

It is to be hoped that the crisis has taught decision-makers that long-term sustainability is an aim, which deserves support through all instruments available to this end. After all, hardly any legal field can be described as 'non-evolving'. Were we to wait for the legal evolution in a particular field to end before adopting any binding legislation hardly any matters in society would be subject to legal regulation. In addition, it should be noted that, since 2001 when the Commission proposed the Modernisation Directive, principles on non-financial reporting have certainly gained considerably wider recognition and support than they had before.

4. Towards more efficient regulation of non-financial reporting in the EU

4.1 Setting the floor for action

Having regard to the differences between the Member States in their requirements on sustainability reporting and in light of the pressure to expand CSR, demands have strengthened recently for improved comparability, reliability and relevancy of the information disclosed by companies. As a consequence, the Commission is showing a commitment to more effective rules on sustainability reporting. Several of its initiatives suggest that we can expect more detailed requirements for sustainability reporting in the future.

In this respect, the EU's growth strategy 'Europe 2020' promotes the renewal of CSR (European Commission 2010). On the basis of this, in its Single Market Act, adopted in April 2011, the Commission again stressed that reforms envisaged should 'contribute to sustainable development, based on a highly competitive social market economy' and that the internal market is based on a 'highly competitive social market economy' (European Commission 2011c: 5), which reflects the trend towards inclusive, socially fairer and environmentally sustainable growth. Most importantly, amongst the twelve levers to boost growth and strengthen confidence, it sets out an initiative to redefine the role of business in today's economy, focusing on improving transparency, particularly in the areas of environment, human rights and sustainable development. The Commission observed that new business models are being used, in which these societal concerns are taking precedence over the exclusive objective of financial profit, and announced that it will present a legislative proposal on the transparency of the social and environmental information provided by companies in all sectors.

In a new package on more responsible businesses published in October 2011, the Commission adopted a new communication, in which it put forward a simpler definition of CSR as 'the responsibility of enterprises for their impacts on society' (European Commission 2011d: 6), and outlined what companies should do to meet that responsibility.[21] In this connection, the Commission emphasised that one of the EU's cornerstone policies is to improve company disclosure of social and environmental information, reiterating its intention to bring forward legislative proposals on this issue.

More specific Commission activities to improve regulation on non-financial reporting began in 2009, when the Commission started its discussions with various interest groups by way of organising a series of workshops throughout 2010. This was followed up in November 2010 when it launched a public consultation on disclosure of non-financial information which ended in January 2011. In relation to that consultation, the Commission reports that half of the respondents described the current regime on sustainability reporting applicable in their respective jurisdiction as poor or very poor (European Commission 2011b). In the process of improving current EU rules on non-financial reporting, the Commission has commissioned the Centre for Strategy and Evaluation Services (CSES) to produce a specific study including qualitative analysis of current reporting practices in the EU and a cost/benefit analysis of non-financial reporting by companies. Furthermore, the Commission has established an Expert/Steering Group on Disclosure of Non-financial information ('the Expert Group'), with the specific mandate to provide expert advice to the Commission (Expert Group on Disclosure 2011b).

4.2 Regulatory alternatives for more efficient non-financial reporting in the EU

When deciding on future approaches towards non-financial reporting, the Commission will have to choose between several alternatives, al-

21. For the ETUC's position on the Communication see ETUC (2011).

though in many cases these can be developed cumulatively. These alternatives range from a number of non-binding (soft law) instruments to strict uniform and binding legislation.

Non-binding instruments to spread non-financial reporting include the sharing of best practices, better guidance and creation of greater incentives for companies within a voluntary regime (e.g. awards for exemplary sustainability reports), industry self-assessment and benchmarks. Furthermore, the EU could also encourage voluntary reporting and promote existing international frameworks for non-financial reporting. In this respect, the Commission could issue a recommendation or guidelines on social reporting, as it has done in relation to environmental reporting, and thus emphasise the benefits of sustainability reporting for a company's reputation and competitiveness. In accordance with their non-binding nature, all these instruments allow for flexibility on the part of the companies preparing reports. At the same time, this implies maintaining the fragmented status quo, in which certain Member States observe high standards whereas others do not. Similarly, it allows companies that perform well with respect to sustainability to prepare reports, whereas other companies do not disclose or selectively disclose aspects that they want to. Namely, if a company performs well with regard to environmental sustainability, this does not necessarily imply that it is also performing well with regard to social sustainability.

In order to ensure clear disclosure requirements, and hence a level playing field, coherence and comparability across the EU, a change in the existing EU legal regime for corporate reporting is needed. As was stated earlier, in this respect, the Commission has promised a legislative proposal on the transparency of social and environmental information on several occasions. Two different legislative instruments are available in that regard: a directive and a regulation. In the field of financial reporting both forms of legislative instrument are used. Directives are employed when certain differences in regulation between the Member States are tolerable. Regulations are adopted when a completely uniform approach is needed in order to ensure the international comparability of the reports prepared by European companies. In the field of non-financial reporting as well, a regulation would be an appropriate instrument should the Commission decide to give binding force to one set of international standards on sustainability reporting (e.g. GRI standards), as has been done in relation to IAS in the field of financial reporting. Since these standards on sustainability reporting are adopted by private entities and do not bind the EU, a regulation of that kind could ensure their legal status within the EU and, at the same time, establish a special committee that would assess individual standards' suitability for EU companies. That committee's endorsement of the standards would introduce them into the EU legal order, hence giving the EU control over the standards applying to EU companies. Despite the advantages of having a regulation in the field of non-financial reporting, given the present state of development of non-financial reporting in the EU, it is hard to expect political support for the introduction of such uniform rules. Even in the field of financial reporting Regulation No 1606/2002 only applies to certain companies (public listed companies) and in relation to particular reports (consolidated accounts). This suggests that when considering future legislation in the field of non-financial reporting, it is more realistic to expect a directive than a regulation.

With respect to a directive on non-financial reporting two alternatives are available. The first possibility is to amend existing EU accounting directives (Fourth and Seventh Company Law Directives) and possibly also the Transparency Directive, which refers to the former two directives in respect of non-financial reporting. The second possibility is to adopt a new directive entirely dedicated to the issues of non-financial reporting. Although both alternatives are acceptable, the advantage of the former is that integration of the rules on non-financial reporting in existing legislative acts on corporate reporting might indicate stronger EU support for the developing concept of integrated reporting. This would make it easier to require integrated reports on both financial and non-financial matters. On the other hand, a separate directive on non-financial reporting could perhaps emphasise more effectively the importance of sustainability reports, although this would probably mean a continuation of the practice of preparing two separate reports, one for financial and the other for non-financial matters.

4.3 Content of the report

What information should European companies be required to disclose?

Although the Commission has already indicated its intention to put forward a legislative proposal on non-financial reporting, this says nothing in relation to the content of such legislation. Two main options exist in this respect: either a principle-based approach or an approach supporting more detailed disclosure of information. A principle-based approach would impose a requirement on companies to reveal whether they have a CSR policy, and, if they do, to indicate how they implement it, and to identify the principal business risks and opportunities arising from social and environmental issues. On the other hand, more ambitious EU legislation in this regard would specify more detailed reporting requirements, requiring disclosure of key information (key performance indicators – KPIs) on issues such as employee engagement, customer satisfaction, public perception of the company, environmental policies and innovation (European Commission 2011b).

In any event, the Commission should at least establish some mandatory principles on non-financial reporting, on which KPIs should be based. In this regard, the Expert Group has agreed that non-financial information should be material, comparable, accurate, timely, reliable, clear, verifiable, forward-looking as well as retrospective (Expert Group on Disclosure 2011c). As regards the more precise content of the report, the Commission can either specify some general issues for reporting and/or establish a detailed list of KPIs. On the first point, the Expert Group agreed that non-financial disclosure should at least cover issues related to human rights, freedom of association, non-discrimination, diversity, equal remuneration, materials and waste, climate change, air quality, energy use and strategy, innovation and anti-corruption. As regards a list of key performance indicators, the Commission can either determine a specific list of reporting requirements or it can refer to one or more existing frameworks. Respondents to the Commission's public consultation generally suggested that appropriate reference to existing international standards and institutions should be made (e.g. to the GRI, UN Global Compact, ISO 26000, OECD Guidelines for Multinational Enterprises, etc.), and argued against the development of new EU-specific frameworks. Should the Commission decide to follow this opinion, it needs to determine all the same whether to select one or more sets of international standards, which should be respected by EU companies when reporting on non-financial matters, or whether the companies themselves should select relevant indicators, ideally in cooperation with their investors and other stakeholders, and disclose information in accordance with those indicators.

Should the Commission decide to select appropriate sets of standards, preference should certainly be given to those that are already accepted world-wide, that are comprehensive and which are both general (i.e. relevant and common to all companies) and also sensitive to the needs of individual sectors. Although none of the international frameworks on non-financial reporting covers all reporting requirements that could potentially be considered, it would be beneficial for the Commission to make such a selection in order to achieve the comparability that is needed and to enable benchmarking. While it is true, as found by the Expert Group, that in comparison with reporting on financial information there is currently no truly globally accepted standard-setter for non-financial information, it must be observed that GRI come very close to this (Expert Group on Disclosure 2011a). It is also to be expected that, should the Commission give preference to one set of international standards on sustainability reporting (e.g. GRI), many other jurisdictions would follow the EU's choice. Furthermore, most of the organisations that set international standards are open to external suggestions on KPIs. In this respect, the EU should ensure its place in the organisation whose standards are to be endorsed in the EU legislation and hence assume a position to influence the content of future standards (such position would indeed be a 'reward' for the EU's support and promotion of the relevant standards). However, of considerably greater importance than the set of standards that might be promoted by the Commission is the question of companies' obligations in that regard. Will the Commission adopt a 'comply or explain' approach or will it introduce mandatory reporting requirements? This is a choice between flexibility and true commitment to sustainability. It is the choice that will have to be made by the EU institutions alone, given that there are irreconcilable differences between the main stakeholders, that is companies, and stakeholders in those companies; the former advocate flexibility and voluntariness, whereas representatives of social and environmental interests rightly emphasise that sustainability reporting should no longer be voluntary in the same way as financial reporting is not.

Worker-oriented reporting

As regards the content of the sustainability reports, social reporting (i.e. reporting on human resources issues) needs to be put on the same footing as environmental reporting. Although employees hold the position of 'the most key stakeholder in their company' (Vitols 2010: 1), employee-related information currently lags behind environmental issues. In addition, current practice at company level varies significantly as far as reporting on employee-related issues is concerned. In general, such reporting is better in companies with worker participation mechanisms (e.g. where a European Works Council is active). Volkswagen is often highlighted as an example of good practice. This is a business where employee representatives are involved in the development and improvement of sustainability reporting systems and in the communication of results to the workforce.

Table 2 **Frequency of reporting on GRI core indicators on labour practices and decent work, top 100 listed companies**

GRI core indicator	Description	% of top 100 listed companies reporting
LA1	Total workers by employment type, employment contract, and region	66
LA2	Total workers by employment type, employment contract, and region	56
LA4	% employees covered by collective bargaining	53
LA5	Minimum notice periods	36
LA7	Rates of injury, occupational diseases, lost days/absenteeism, number of work related fatalities by region	65
LA8	Education, training, counselling, prevention etc. regarding serious diseases	55
LA10	Average hours of training per year per employee by employee category	56
LA13	Composition of governance bodies and breakdown of employees per category according to gender, age group etc.	62
LA14	Ratio of basic salary of men to women by employee category	30

Source: Vitols (2010).

This differentiated practice is a result of undeveloped legal rules and the prevailing voluntariness in the field of sustainability reporting in the EU. A Commission workshop held with trade unions gave them an opportunity to present their views on the matter. This revealed that trade unions would like to see the current regime replaced with a disclosure regime having the following characteristics:

– mandatory disclosure requirements applying not only to listed companies but also a broad spectrum of unlisted firms (including SMEs);
– reporting on a wide variety of ESG indicators;
– standardisation of indicators to improve comparability over time (e.g. to measure progress) and across companies;

- inclusion of 'special situations' such as restructuring in the mandatory disclosure regime;
- expansion of indicators to improve supply chain disclosure;
- a participatory approach which includes workers and their representatives in the development and improvement of reporting systems, monitoring of progress and negotiation of sustainability strategies and goals.

Although the EU is confronted with a challenge to improve the whole regime on sustainability reporting, this is even more acute as regards social reporting. The fact that environmental reporting has been of greater concern to the EU than social reporting is evident from the 2001 Recommendation which is limited to the reporting of environmental aspects. This divergence between environmental and social issues can be discerned also from the report on the application of the Unfair Commercial Practices Directive. This addresses issues of unfair commercial practices in relation to the environmental impact of products but does not mention any social issues (European Parliament and the Council of the European Union 2005). Similarly, the Commission adopted the 'Buying green' handbook on environmental public procurement in 2005, whereas it took five years before an equivalent in the social field was adopted. As emphasised by the ETUC, 'particular vigilance will be needed … to ensure better integration of both social and environmental considerations' (ETUC 2011, para. 17), not only in respect of public procurement and unfair commercial practices, but also in respect of corporate reporting regulation. In contrast to the many shareholders increasingly taking a short-term approach towards the company in which they invest, employees have long-term interests and, correspondingly, also adopt a long-term approach. This therefore justifies why the latter group should have a right to be informed on the impacts their company has on a wide range of indicators, including environmental indicators, which have the most direct impact on employees' health and safety, and should have a more extensive role in reporting and sustainability initiatives at the company level.

4.4 Other issues on non-financial reporting to be decided

Which companies should be required to disclose non-financial information?

In the context of the ongoing reform of corporate reporting, one of the most important issues to be determined is which companies should be required to disclose non-financial information. This is primarily, but not exclusively, a question of size. Having regard to their impact on the economy and local communities and as leaders of business trends, the prevailing opinion is that large companies should be required to report on non-financial aspects of their business. However, as regards SMEs, opinions vary considerably.[22] Respondents to the Commission's public consultation suggested a phase-in approach, where the introduction of a new reporting requirement could apply, first, only to large companies, and later, following evaluation, to medium-sized companies. In addition, a significant majority of respondents agreed that small enterprises should not be subject to any mandatory requirement, in light of the administrative burden this would entail. This argument was countered by respondents who pointed out that, although not individually, in collective terms SMEs have a large impact on society and the environment, and for this reason should be included in the reporting of non-financial information. This is in line also with the principles of integrated reporting, where small companies are required to report, but subject to less stringent rules. Consequently, should the EU support integrated reporting, a coordinated approach towards financial and non-financial reporting will be needed.

A specific issue is whether institutional investors (e.g. pension funds) should be subject to specific or additional disclosure requirements, e.g. how environmental and social issues affect their investment decisions. This would be important in order to enhance long-term investment performance, while at the same time increasing transparency to their clients and stakeholders and would thus encourage those investors towards taking more sustainable action. In this respect, one of the UN Principles for Responsible Investment (UN PRI) – Principle No 3 states: 'We will seek appropriate disclosure on ESG issues by the entities in which we invest'. In pursuit of that approach, it proposes that institutional investors could:

– ask for standardised reporting on ESG issues (using tools such as the Global Reporting Initiative);
– ask for ESG issues to be integrated within annual financial reports;

22. For a definition of small and medium-sized companies for these purposes see Article 11 (small) and Article 27 (medium-sized) of the Fourth Company Law Directive (Council of the European Union 1978).

- ask for information from companies regarding adoption of/adherence to relevant norms, standards, codes of conduct or international initiatives (such as the UN Global Compact);
- support shareholder initiatives and resolutions promoting ESG disclosure (PRI 2012).

Finally, in relation to the addressees of the disclosure requirements, any future legislation on sustainability reporting will have to settle the issue of reporting boundary. This will entail a provision determining whether a report should simply include information at group level (the parent company and its subsidiaries) or go beyond this to include undertakings within the sphere of influence of the reporting company. In this respect, the first alternative will probably be sufficient to obtain adequate information on a company's sustainability performance and, at the same time, ensure legal certainty without imposing an excessive administrative burden upon the preparers of reports.

External assurance/auditing

A further key issue to be addressed by future EU legislation concerns the question of whether non-financial information disclosed should be audited by external auditors or at least get some sort of external assurance. It is beyond doubt that there is value in getting non-financial reports assessed by independent experts in order to improve accuracy, completeness and comparability and enhance confidence amongst stakeholders (European Commission 2011b). Although this involves costs for companies, such cost should not be considered undue considering the limited value of unverified reports. Furthermore, although external assurance of non-financial information involves activities and qualifications significantly different to those required for auditing financial statements, this does not justify legislative approval of reports that are not externally assured. In line with the principle of proportionality, SMEs should perhaps be allowed to provide assurance opinions only rather than full audits, which would significantly limit the costs while forcing companies to prepare truthful reports. Additionally, the Commission should consider putting companies under an obligation to publish non-financial information online. As emphasised by the Commission's Expert Group, 'reports published online are de facto exposed to "public verification"' (Expert Group on Disclosure 2011b). This would enable all stakeholders (employees, consumers etc.) to verify the reports directly. In any event, internal stakeholders ought to be engaged in the preparation of sustainability reports and not simply informed of the content of the final version. As stressed by the ETUC, 'the presence of trade unions is the most effective monitoring system and mechanism for addressing grievances' (ETUC 2011).

5. Conclusion

Short-term and socially irresponsible decision making in many companies has caused the crisis. To bring the EU economy out of the crisis and to prevent repetition, a fully engaged orientation towards sustainable development is needed. Sustainability reporting is an important instrument to achieve this objective, given that disclosure of certain aspects of business activities stimulates companies to actually perform better in the fields they report on. For the EU to achieve these objectives it needs to establish solid legal foundations for effective sustainability reporting that will establish a level playing field across the internal market. The legislation should bind all or at least the vast majority of business entities, which should be required to report on all the important environmental, social and other non-financial aspects of their businesses that affect sustainable development in society. Such information should be clear, precise, and verifiable and should enable comparisons across the EU.

It is understandable and necessary that, in the process of proposing and adopting legislation on sustainability reporting, EU institutions balance various costs that sustainability reporting requirements will have on European companies. These include increased administrative burdens and costs in the form of data collection, staff training, third party evaluation and assurance, etc. Nevertheless, the fear of cost should not lead to legislation of a kind that would prevent any serious achievements in the field of sustainability reporting and jeopardise sustainable development in general. Leaving disclosure of non-financial information voluntary or limiting this obligation to large companies only or to general non-financial information that need not be externally verified would indicate that the EU is not seriously committed to sustainability. On the other hand, costs of high standards in relation to non-financial reporting can be alleviated if one considers that publishing costs can be reduced if templates are offered. Furthermore, after the first year of reporting the costs of maintaining the reporting activities are no longer substantial. In response to the Commission's public consultation, contributions from Member States with more extensive requirements did not report that these lead to excessive administrative burdens. Moreover, companies should regard sustainability reporting as something that may benefit themselves, much the same as financial reporting does, and see the benefits of data collected for better risk control, cost management and better overall definition of corporate strategies. Consequently, although flexibility is an important aspect to be considered when preparing any legislation, in the context of sustainability reporting legislation it should not be to the level that sustainability itself would be at risk.

Furthermore, it makes sense to support integrated reporting, as this could contribute significantly to mainstreaming environmental and social issues and raise awareness about the links between financial and non-financial information. This would give a holistic view about a company's activity and help stakeholders realise that the financial results of a company are only one part of its impacts. The EU should also work in close cooperation with the International Integrated Reporting Council (IIRC) and in the future potentially endorse standards on integrated reporting adopted by the IIRC.

As the Commission's Expert Group found, 'better disclosure of social and environmental information could enhance the accountability of enterprises, and consequently contribute to greater public trust in business'. In order to stabilise the EU economy such public trust is imperative.

'There is nothing more wasteful than wasting a crisis'
Rahm Emanuel

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