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POLICY BRIEF

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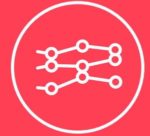

Accounting for a Sustainable European Economy?

Key points

- Since 2017 around 8,000 European companies have been obliged (in accordance with Directive 2014/95/EU) to submit non-financial reporting on environmental, social and labour issues, respect for human rights, and the fight against corruption and bribery – with the aim of presenting companies' sustainability performance.
- National and international studies show that this reporting obligation has so far been implemented only unsatisfactorily in practice. In Austria, for example, it must be noted that only a small group of companies (only 0.09% of all corporations) is subjected to these requirements and that their non-financial reporting is often inadequate.
- To ensure that the objectives of the EU Directive are achieved, the European legislator is called upon to take action. In the course of the revision of the non-financial reporting obligations, which has been scheduled by the EU Commission for the year 2020, further improvements in the regulatory framework are urgently needed.
- Three main points of focus should be: extension of the scope, the clear definition of the reporting obligations' minimum contents, and the establishment of a mandatory external audit regime on a par with financial reporting.
- The European economy needs clear legislation on what non-financial reporting should look like. According to the dictum „What gets measured gets done", companies are required to make their contributions to achieving the Sustainable Development Goals (SDGs) and the European climate and energy targets – and to account for them based on transparent, comparable and valid non-financial information and performance indicators.

Introduction

After first steps which were undertaken at the turn of the millennium, the concept of non-financial reporting was first widely implemented by the Directive 2014/95/EU. Since 1 January 2017, around 8,000 companies in the EU have been obliged to provide a transparent account of selected aspects of their sustainability performance once a year. This is intended to raise awareness of corporate social and environmental responsibility. Stakeholder groups (e.g. employees, suppliers, customers, NGOs, …) have already started to use this new information to assert their interests. And the European legislator also attaches great importance to non-financial reporting by building on the non-financial information generated for further legislative initiatives: these include the „Action Plan: Financing Sustainable Growth" (2018) and the „Green New Deal" (2019).

The current high demands for such extended corporate reporting are confronted by obstacles which have been encountered eversince the development of Directive 2014/95/EU. As sustainability reporting had been previously handled very differently in EU Member States, the ambitious efforts of the EU Commission met with great resistance from the beginning. The directive that was finally adopted is essentially a political „compromise". Inconsistencies in content and generous Member State options impaired the implementation of the law in the EU and continue to have a (negative) impact to this day. Numerous Member States – such as Austria and Germany – have decided to adopt only minimum standards, without eliminating deficits in the underlying European law. During the legislative process in Austria (2015) the Chamber of Labour already indicated what the legislator should concentrate on with regard to national implementation (e.g. scope and review).

Main findings

AK study: Further development of non-financial reporting requirements

Directive 2014/95/EU was implemented in Austria in December 2016 with the Sustainability and Diversity Improvement Act (NaDiVeG). Since then, large corporations that are also public interest entities with more than 500 employees have been required to report non-financial information. In an initial estimate, the legislator assumed that it would include around 125 companies or groups. However, as a study by Development International (2019) shows, considerably fewer – namely only 89 companies (= 0.09% of all corporations in Austria) – are likely to be subject to the reporting requirement. This deficit has implications for some of the largest groups in the country (e.g. because they are not listed on the stock exchange, for example), which is not conducive to transparency.

In 2019, the Vienna Chamber of Labour evaluated the implementation of the NaDiVeG in the second reporting season and hence for the 2018 financial year: The results of the corresponding study of the Vienna Chamber of Labour „Eine Evaluierung der Umsetzung des NaDiVeG in börsennotierten Unternehmen" (An Evaluation of the Implementation of the NaDiVeG in Listed Companies) are consistent with other findings for both an Austrian and European context. This survey is thus of importance for reform projects at EU level beyond a national context as well. The findings can, therefore, make a valuable contribution to the deliberations on the revision of Directive 2014/95/EU, which the EU Commission has announced for the 4th quarter of 2020.

Reporting form and integrated reporting

The vast majority of Austrian companies make use of the option to fulfil their reporting obligations in the form of a separate non-financial report. One half of these companies published their non-financial report as a section of their annual report („combined reporting"), while the other half chose to publish it as a separate, stand-alone document („sustainability report"). Only in exceptional cases is an „integrated (annual) report" provided – following the relevant reporting concept of the International Integrated Reporting Council (IIRC).

It follows that there is a high degree of separation between financial and non-financial reporting in Austrian reporting practice, which reflects more the tradition of (voluntary) sustainability reporting than the desired integrated reporting. This is also reflected in the implementation of the legal requirement that non-financial performance indicators must be explained by „references to, and additional explanations of, amounts reported in the annual financial statements". In about one third of companies, the information is not linked as required by the law. Another fly in the ointment: Those two thirds of the companies that take this requirement into account do so only to a limited degree.

Framework

Irrespective of the choice of reporting format, the following tendency can be observed when using the frameworks: The guidelines of the Global Reporting Initiative (GRI) were used throughout, and only in one case was the framework of the IIRC also used. There are, however, major differences in application – both in terms of scope and (formal) reporting. This makes it difficult to trace the information provided and results in limited comparability.

Report limits

Another very problematic issue is the question of reporting boundaries, i.e. how group companies and – upstream and downstream in the value chain – other companies are included in non-financial reporting. In fact, three-quarters of the reports do actually contain general statements on this subject, while the rest remain silent on this aspect. Cases should be viewed critically where reporting is restricted to group companies in individual countries, of a certain size or even only to individual locations, without full justification for doing so. This does not guarantee (the desired) complete reporting; this is due not least to the fact that the legal texts do not contain any explicit statements on this.

Materiality analysis

The heartpiece of non-financial reporting is the so-called „materiality analysis". All issues that are of major importance for the company as well as for stakeholders (employees, works councils, customers, society, environment, etc.) are identified – such as working conditions, CO2 emissions, etc. In practice, a great deal remains to be done, in terms of quantity alone: The average report on this issue comprises under three pages; reports range from 1.5 to 13.25 pages. But there is also room for improvement in terms of quality: Orientation is often based on the guidelines adopted from sustainability reporting (mostly GRI). With the help of these standards an attempt is made to specify the vague legal requirements for practical implementation. In contrast, however, the special features of the requirements of the EU Directive are hardly mentioned.

Reporting contents

The five minimum matters set out in the law (environment, social and employee matters, respect for human rights and anti-corruption and bribery matters) are covered to varying degrees and depth, which makes it difficult to compare even companies in the same industry. Here, quite different interpretations of the materiality principle offer (too) much room for judgements for companies subject to reporting requirements. Nevertheless, even in this respect, as well as in the subsequent minimum disclosure requirements, there are numerous examples of companies that do not fully comply with their reporting obligations. In contrast, measures that serve to secure or improve sustainability performance are often given greater focus without substantiation through non-financial performance indicators („greenwashing").

Verification

According to NaDiVeG, the supervisory board must verify whether the company's non-financial reporting is legal and appropriate. However, the results of the study by the Vienna Chamber of Labour have shown that supervisory boards only deal with this aspect to a very limited degree and that boards are (still) likely to lack the necessary expertise to do so. The supervisory board can also fulfil its duty of care by commissioning a voluntary external audit (which is only done in a few cases in Austria). Where auditors were employed, however, they usually based their work on minimum standards: Audits were carried out based on the concept of "limited assurance" throughout, which means that the audit certificate falls short of the legal requirements for the audit by the supervisory board ("reasonable assurance"). Unless the supervisory board itself has undertaken additional audit procedures, no company has performed a legally compliant verification of the content of non-financial reporting. Supervisory boards and auditors are apparently still unaware of the scope of the legal requirements and lack suitable methods to comply with these requirements.

Conclusion

In summary, it can be seen that the NaDiVeG and the underlying Directive 2014/95/EU are in need of improvement and that practical implementation is still in its infancy. The following visualisation summarises main points of criticism:

Starting points for the further development of non-financial reporting requirements

Scope	• Minimum scope of application not logical and too restrictive • Questions of interpretation of the relationship between the delimitation criteria
Contents	• Lack of definition of the principle of materiality • No minimum set of performance indicators, thus limiting comparability • Unclear legal terms requiring recourse to different frameworks (such as the Global Reporting Initiative's standards) • Consequence: Incomplete reporting, also through incorrect referencing methods • No linking of financial and non-financial performance indicators
Formal aspects	• (Too) High degree of freedom in the use of reporting frameworks • Non-financial report does not fit sufficiently into the legal context and leads to problematic questions of interpretation
Verification	• Lack of awareness and sustainability expertise on the supervisory board • Unclear requirement profile of external audit service providers • Attestation with limited certainty of verification (i.e. limited assurance) not sufficient for a substantive, external audit

Source: Vienna Chamber of Labour, 2019

Demands

In the light of the high relevance of the targets, aimed at by the concept of non-financial reporting and the deficits that exist in practice at the same time, the following points should be addressed in the revision of Directive 2014/95/EU:

- **Extension of the scope:** The scope of non-financial reporting requirements in the EU should be extended to all large corporations and to companies that are majority-owned by the federal government.
- **Definition of a mandatory minimum set of reporting topics and performance indicators:** First, the principle of „materiality" must be explicitly specified in Directive 2014/95/EU. However, European companies must also be given clear guidelines on how to report correctly and comparably. From the point of view of the Chamber of Labour, it must be emphasised that the interests of the employees (such as ILO core labour standards, ...) must be adequately considered.
- **Obligations of management and supervisory boards:** European business leaders need to develop an understanding of sustainable business management. Incentives are needed: non-financial targets must be more firmly anchored in the remuneration policy for the board of directors. The supervisory board again has a key role to play in further developing the quality of non-financial reporting. As is the case with financial experts, a sustainability expert should therefore be represented on the supervisory body. At EU level, this requires corresponding adaptation of the standards framework in which Directive 2014/95/EU is embedded.
- **Mandatory external audit:** External audits must be mandatory – in terms of form and content and providing the same level of assurance as for financial reporting. To do so, the requirements profile of the service providers must be developed further. In this regard further efforts at the level of European enforcement mechanisms should also contribute to ensuring the validity of the reports submitted.

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Authors

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Josef Baumüller, josef.baumueller@wu.ac.at
Alice Niklas, alice.niklas@akwien.at
Christina Wieser, christina.wieser@akwien.at

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