DEFINING THE IMPACT OF NON-FINANCIAL REPORTING ON THE PROCESS, INSTRUMENTAL AND INSTITUTIONAL DIMENSIONS OF CORPORATE GOVERNANCE

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Abstract With the adoption of the Non-Financial Reporting Directive (NFRD) and the Corporate Sustainability Reporting Directive (CSRD), selected companies have to include and publish non-financial information in the course of their annual business reports (such as environmental and social matters etc.). This paper aims to determine the methodology and develop a research model to evaluate the impact of non-financial reporting requirements on the selected companies' process, as well as instrumental and institutional dimensions of corporate governance. Research methodology and research model will be defined in application with the MER model of integral management and governance (MER model). In connection with the MER model, this paper aims to contribute to the theoretical body of literature by developing a new research model using NFRD, CSRD, and EFRAG requirements to measure how non-financial reporting impacts process, instrumental and institutional dimensions of corporate governance. This paper also sought to illustrate the value and expected results of the future study when the research model is used in an empirical survey. A company must meet non-financial reporting requirements through all three dimensions of governance (process, instrumental, and institutional) to contribute to the company's long-term success, the well-being of society, and the achievement of sustainable development goals.

Keywords: non-financial reporting, integral management, sustainability, corporate governance, MER model of integral management and governance

JEL: M14, Q01, Q56

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1 Introduction

Due to several financial crises, environmental accidents, and employment matters recently, stakeholders and investors have raised concerns regarding corporate governance and corporate reporting. Especially in the last decade, corporate reporting has extended beyond traditional financial reporting including the reporting of non-financial information. In the first stage, this information was mainly reported voluntarily, mostly prepared based on guidelines delivered by different standards setters and organizations (such as GRI and IFRC). The content of this information included mainly the management and disclosure of risks and related policies. Over time, they have evolved to information concerning environment and social sustainability, business model, corporate governance, etc. (Cinquini & De Luca, 2022). With the adoption of Directive 2014/95/EU (hereinafter: NFRD), certain companies (entities of public interest with more than 500 employees) were obliged to report non-financial information as part of their year-end reporting. All countries of the EU adopted the NFRD, and selected companies had to report the first non-financial information for 2017. Due to several shortcomings of the NFRD, mainly related to comparability issues and auditing, the EU adopted the Sustainability Reporting Directive (hereinafter: CSRD). The CSRD introduced a more detailed reporting requirement, EU sustainability reporting standards (issued by the European Financial Reporting Advisory Group (EFRAG)) and extended the scope of companies obligated to report the information. In addition to the NFRD and the CSRD, the EU has adopted other legislation, such as the Directive on corporate sustainability due diligence (CSDDDD) and Taxonomy regulation. However, even though the EU has taken regulatory actions to increase sustainable corporate governance, the question remains whether the company's reported sustainability information is integrated into its governance structures. To prove this question, we focus on the determination of methodology and development of a research model in this paper to evaluate the relationship between non-financial information disclosure and corporate governance structure.

2 Literature Review

Corporate social responsibility was introduced in early 1950 with the book "Social Responsibilities of Businessman". In the book, H. Bowen addressed how much social responsibility can be rightly expected from a businessman by the public (Bohinc, 2016). Over the following years, the term has evolved into ever greater dimensions (Benn et al., 2016; Carroll, 1979). By introducing new terms, various authors have emphasized that social obligation has become too broad to promote effective CSR management (Bohinc, 2016; Maignan & Ferrell, 2004). Based on content analysis of 37 definitions of SRD, Dahlsrud (2008) defined CSR as a specter of five dimensions: environmental, social, economic, stakeholder, and voluntariness dimensions. At the end of the 20th century, an international standard of social responsibility, ISO standard 26000, was introduced, showing the development and extended meaning of CSR in previous years (Primec & Belak, 2022). In this dynamic context, previous research has shown that non-financial reporting has been applied worldwide in the past decade. However, to achieve comparability of non-financial information, it was evident that there was a growing need for convergence among different non-financial reporting frameworks (Cinquini & De Luca, 2022).

In the EU, the concept of CSR was first implemented voluntarily with the aim that companies would integrate social and environmental matters into their governance by themselves. The financial crisis and the collapse of organizations showed that the voluntary concept of reporting was ineffective and that most companies did not provide a comprehensive overview of the risk they faced. Growing pressure was experienced from investors and standard-setting bodies toward the adoption of sustainable corporate governance (Dobija et al., 2023). Thus, the EU has introduced the NFRD, which made it compulsory for certain large undertakings and groups to report and manage their non-financial risks and opportunities. The NFRD consists of two parts. The first part presents the diversity policy. It represents the company's management or supervisory bodies regarding gender, age, or education. It includes the indication of the objectives, manner of implementation, and the results achieved by the diversity policy during the reporting period (Belak & Primec, 2020). Based on previous studies, diversity policy shapes the company's decision-making process and provides an essential driver of sustainable development (Dobija et al., 2023). The second part presents the non-financial statement. Companies shall prepare a non-financial report that includes at least environmental and social matters, employee-related issues, respect for human rights, and anti-corruption and bribery. Companies shall report policies, outcomes, and risks (Primec & Belak, 2017). In 2020, the European Commission published a document in which they emphasized that the NFRD has led the companies to change their strategies into a different, more social form of governance by including non-financial risks they encounter in their operations.

However, based on multiple studies, it was emphasized that the NFRD falls short in providing harmonized reporting due to integrated reporting and assurance and to excess possibilities for the company to diverge from reporting requirements (Parguel et al., 2011; Primec & Belak, 2022; Reddy, 2019). To resolve the identified shortcomings, the EU adopted the CSRD. The CSRD supersedes and complements the NFRD. Compared to the NFRD, the CSRD increases the number of companies that will be obliged to report the scope of the requirements and assurance. Companies will be obliged to report under the CSRD from the year 2025 on (the financial year 2024). To assure that the NFRD and the CSRD will meet the objectives set by the EU, it is, therefore, of high importance that sustainable governance is implemented in the whole structure of the company and its environment. The MER model on integral management and governance (hereinafter: MER model) is based on the multi-dimensional integration of control with the company and its environment considering the primary purposes of surviving and developing (Belak & Duh, 2012). The structure of the MER model is visible in Figure 1 and includes (Belak & Duh, 2012):

- integral management dimensions and special management which include process dimension, institutional dimension, and instrumental dimension,
- enterprise which includes the life cycle, developmental and growth cycle of an enterprise, objective, time and space dimensions, and its environment, which provides for economic environment, technological environment, sociopolitical and other social environments, natural environment, and cultural environment,
- key success factors of an enterprise which include credibility, ethics, ecology, efficiency, entrepreneurship, competitiveness, synergy, compatibility, culture, and philosophy.

The MER model defines that process, institutional, and instrumental dimensions have to be integrated into one holistic and complex cooperation process. All three integral management dimensions must be implemented at three levels of an enterprise: policy of the enterprise, strategic management, and tactical/operational management (Belak & Duh, 2012).

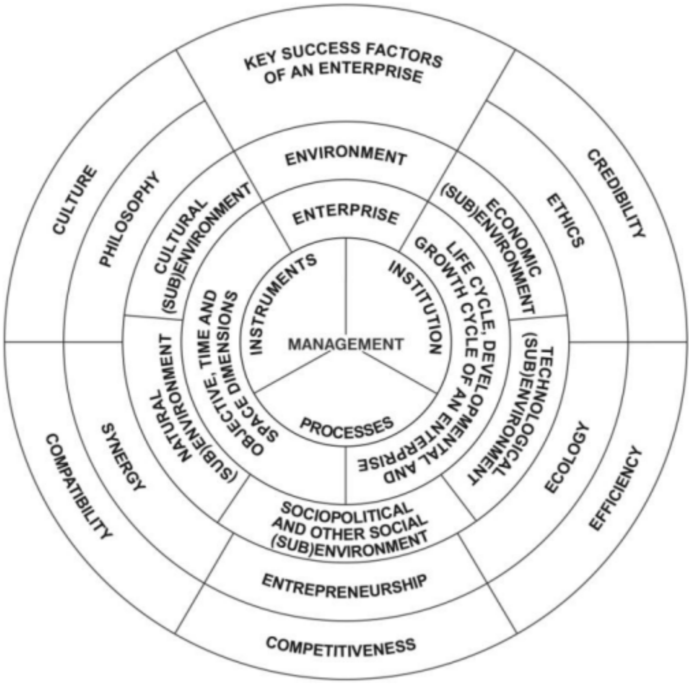

Figure 1: The MER model of integral management and governance
Source: Belak and Duh (2012).

3 Methodology

A research model for investigating the NFRD and the CSRD impact on the process, instrumental, and institutional dimensions of corporate governance was defined in application with the MER model of integral management and governance. Based on the prepared research model, it is investigated whether the NFRD and the CSRD provisions impact process, instrumental, and institutional dimensions in all three hierarchical levels (policy of an enterprise, strategic management, tactical and operational management) of a company. To this aim, seven categories were developed in the research model for the following groups of information:

- C1: companies' mission, purposes, and primary goals on the policy level,
- C2: corporate, general, and business strategies on the strategic management level,

- C3: implementation of policy and design strategies on the tactical and operational management levels,
- C4: description of the planning, organizing, directing, and controlling,
- C5: an overview of preparatory information activities, decision-making, and measures undertaken as process functions,
- C6: an overview of values, business and management guiding principles, styles, techniques, and management methods,
- C7: an overview of corporate governance institutions.

The first group (C1) of the information includes the companies' mission, purposes, and primary goals on the political level. Based on the research model prepared, it is investigated whether the company reported any sustainable-oriented mission, purpose, and basic goals (such as managing non-financial risk) in their annual reports. Further, it is explored in the second (C2) and third (C3) groups whether a sustainably oriented mission, purposes, and basic goals are also described as the basis of companies' strategies (corporate, general, and business) and how the implementation of the strategy on the tactical and operational management levels of the company is planned or was already executed. The fourth (C4) and fifth (C5) groups of the research model include the essential functions of planning, organizing, directing, and controlling, as well as the process functions of an overview of preparatory information activities, decision-making, and measured undertaking. Based on the research model, each essential and process operation will be investigated on policy, strategic management, and tactical/operational levels. In particular, it will be evaluated whether the company included basic and process functions in any of the above-mentioned hierarchical levels (policy level, strategic management level, and tactical/operational management level) when reporting non-financial information. The sixth group (C6) includes an overview of values, business and management guiding principles, styles, techniques, and management methods which the company reported in their annual reports to non-financial disclosure. Based on the research model, it will be investigated whether the company reported any styles, techniques, tools, instrumentation, and methods (such as policy, codes, semi-consolidated plans, guidelines, rules of procedure, etc.) concerning the management of risk and sustainability matters requested by the NFRD and the CSRD. The seventh group (C7) contains a description of corporate governance institutions. Based on the research model, it will be investigated whether the company described/reported any governance institutions (such as committees for sustainable risks) and their functions to govern and manage sustainability matters requested by the NFRD and the CSRD.

The most suitable companies for the research are those that are committed to sustainability reporting following the NFRD and the CSRD. Hence the research model will be most applicable in the period from 2018 onwards (covering the financial year 2017) when companies had to start reporting under the NFRD. The empirical research will be conducted in two phases. In the first phase, the research model will be used to assess non-financial information published by selected companies in their annual or sustainability reports. Multiple case studies will be used since they enable the researcher to focus on specific examples or phenomena. Such a methodology aims to research and understand the real and reciprocal functioning of variables or events (Primec & Belak, 2022; Yin, 2016). Based on the information received from the annual and sustainability reports, sustainability reporting categories will be shaped and assessed. Each category of information will be assessed in two timeslots. In both timeslots, it will be evaluated whether the company reports the information requested per each of the above categories and whether the reported information complies with the NFRD and the CSRD. When the results for each time slot are prepared, a comparison analysis will be processed as part of the second phase of the empirical research. The comparison analysis will be made between the data reported in the first timeslot and the data reported in the second timeslot. The quality of information gathered from the results will indicate whether the quality of the information reported has improved. The quality of information disclosed shall be assessed based on content analysis. Content analysis grants replicable and valid inferences from the text and was used for sustainability reporting analysis in the past (Nicolo et al., 2020). Based on information gathered from the reporting and the usage of the research model, it will be examined whether the company complies with and reports the information stated in the categories described above.

Based on the research model prepared, we expect to answer the following designed research questions whether and how the NFRD and the CSRD legislation, in line with the MER model of integral management and governance, influence:

- the content of the vision, mission, purposes, and basic goals (within the process dimension); the core strategies, business strategies, and overall strategies (in the context of the process dimension); the tactical and operational level of the implementation of policies and procedures (within the process dimension) of selected companies.

- the values and management principles and the application of styles, techniques, tools, instruments, and methods (in the context of the instrumental dimension) at the corporate policy level, strategic management level, and operational and tactical management level of the selected companies.
- the governance institutions (in the context of the institutional dimension) of the selected companies; the corporate governance institutions (in the context of the institutional dimension) of the chosen companies; the middle and lower management institutions (in the context of the institutional dimension) of the selected companies.

4 Results

With the development of methodology and implementation of the research model in practice, we expect to identify whether regulatory actions, such as the NFRD and the CSRD, influence corporate governance. In particular, the results will indicate how the provisions of the NFRD and the CSRD affect the corporate governance of companies in practice. The results will also show whether sustainability reporting has improved since the implementation of the NFRD and whether the adoption of the CSRD had any impact on companies' sustainability reporting in practice. We also expect that the results analyzed by the research model will indicate whether the implementation of the NFRD and the CSRD influenced the quality of corporate governance. The research model will enable the comparison of different non-financial reporting practices and their influence on sustainable corporate governance.

5 Discussion and Conclusion

In this paper, we briefly define a methodology and research model which can be used to determine and investigate the connection between non-financial reporting and corporate governance. To achieve the company's and its stakeholders' long-term success, sustainability and corporate social responsibility must be implemented in a company's corporate governance structure. This research model can provide valuable insights into companies' reporting in practice. Due to upcoming legislation changes, the research model also brings further insight into how legislation affects/changes non-financial reporting and sustainable corporate governance. To improve the results obtained from the research, interviews may be conducted with the companies selected for the study as a second method to gather additional insights.

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