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Beyond Financials: Understanding the Implications of NFRD and CSRD on Non-financial Reporting

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In an area where transparency and accountability are two crucial corporate governance factors, the Non-Financial Reporting Directive (NFRD) and the Corporate Sustainability Reporting Directive (CSRD) present key legislative acts to foster these principles. Both directives determine that selected companies must include and publish non-financial information in their annual business reports (such as environmental and social matters, human rights, etc.) alongside financial ones. NFRD and CSRD have been implemented for companies to report more comprehensive information about their operations, informing all interested individuals and groups about the information they need for their decision-making, thereby reducing risk, extending the scope of information, and providing a comprehensive view of the company's management. Both directives determine how companies report on their social and environmental impact and signal a shift towards sustainable CSR business practices. This paper aims to determine the methodology and develop a research model to evaluate the effect of NFRD and CSRD on non-financial information reporting in practice.

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1 Introduction

Companies are composed of numerous interests and processes that intertwine with each other. Their operations are thus interwoven and connected with numerous interests. Likewise, the operation of a company affects many stakeholders who are directly or indirectly associated with the company (such as shareholders, employees, suppliers, customers, etc.) (Cinquini & De Luca; 2022; Čufar & Primec, 2021). To increase transparency in business operations, financial reporting by companies has emerged in the past. That has gradually become standardized and comparable. Financial data have provided stakeholders with information about the operation of the company and its performance. However, from the perspective of data comprehensiveness, such information only represented the performance of the company from an economic/financial viewpoint (Ellili, 2022). The incompleteness of such reporting was demonstrated by the future performance of companies. Specifically, within the context of financial crises under which companies found themselves in crisis and, in some cases, even failed. It was discovered that companies had excessively relied on generating revenue and profit while simultaneously taking on excessive risks that were unsustainable for them (Al Hawaj & Buallay, 2022; Cinquini & De Luca, 2022). Based on these shortcomings, the need for more comprehensive reporting of information emerged. Primarily, a need emerged for reporting that would reveal additional risks associated with the operation of the company, which would inform key stakeholders about factors and risks not related to the financial operations itself (Buallay, 2022). For this purpose, the EU implemented the NFRD and later, the CSRD. Both directives are part of the EU's efforts to enhance transparency and accountability in the business sector, particularly regarding environmental, social, and governance matters (Christensen et al. 2022; Greiling & Bauer, 2023; Turzo et al., 2022). In recent years, the EU has increased its interests and adopted legislation supporting the sustainability and resilience of companies. Alongside the NFRD and CSRD, it has implemented the Directive on corporate sustainability due diligence (CSDDDD) and the Taxonomy Regulation. Despite established legislation and the EU's commitment to promoting sustainability, questions remain about whether legislation (such as the NFRD and CSRD) impacts non-financial reporting in practice. This paper will develop a methodology based on NFRD, CSRD, and ESRS criteria to define and measure how NFRD and CSRD impact non-financial reporting in practice (Primec & Belak, 2022).

2 Literature review

Past research suggests that there are several criticisms and skepticism toward the sustainability reporting of information (Cho, 2015, Turzo et al. 2022). Critics accuse sustainability reporting of lacking comparability of reported data, credibility, and relevance, which would contribute to informed financial reporting. Critics of sustainability reporting also argue that sustainability reporting is a facade that companies use to gain media attention. Sustainability information often lacks clarity and comparability. Instead of ensuring the legitimacy of the company, it undermines it (Abhayawansa et al., 2018; Cho, 2015). On the other hand, there are advocates for sustainability reporting who argue that when companies do not disclose sustainability information transparently and when they ignore sustainability risks, they face increasing skepticism from key stakeholders and incur higher capital costs. In addition, sustainability reporting provides essential assistance to companies for the constantly changing climate environment (Bebbington, 2018). A study from 1995 showed that the implementation of sustainable reporting can improve a company's legitimacy (Suchman,1995). From a sustainability perspective, there is a significant connection between ESG and the actual performance of a company. Past research also demonstrates that the introduction of mandatory sustainability reporting improves company performance in certain circumstances (Buallay, 2022; Ellili, 2022). Disclosing sustainability information has a favorable impact on investment efficiency factors. Companies should improve the disclosure of sustainability information, enhance the quality of their financial reports, and adhere to existing sustainability reporting standards to improve their operations. Despite the existing question of appropriateness between voluntary and mandatory reporting of sustainability information, there is a demand among investors, financial analysts, and other key stakeholders for greater disclosure of sustainability information (Al Hawaj & Buallay, 2022; Buallay, 2022; Krasodomska, 2017).

Sustainability reporting is closely related to Corporate social responsibility (CSR). Upon reviewing the literature, numerous definitions of CSR can be found. Among others, in its Green Papers from 2001, the European Commission defines CSR as "*a management concept whereby companies integrate social and environmental concerns in their business operations and interactions with their stakeholders*" (Commission of the European Communities, 2001). World Business Council on Sustainable Development (WBCSD) defines CSR as: "*Corporate social responsibility is the commitment of business to* *contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve the quality of life.*" (WBCSD, 2000).

Over time, the term has expanded into larger and more extensive dimensions (Benn S. et al., 2016; Carroll, 1979). In the economy, it is possible to observe an increasing number of companies that report sustainability information to their stakeholders and emphasize the importance of CSR. Through the introduction of new terms, social responsibility has expanded to a point where it has become too broad to foster the promotion of CSR management (Bohinc, 2016; Maignan & Ferrell, 2004). Additionally, the number of CSR data disclosures has increased in recent years. It is important to highlight that the majority of these disclosures were made voluntarily and were not mandatory (Christensen et al., 2021). At this level, companies primarily used sustainability reporting as a means of communicating their expected financial performance, reducing capital costs, and decreasing information asymmetry. Numerous measures and initiatives have been implemented in recent years to promote sustainability and non-financial reporting. Consequently, non-financial reporting has been utilized on a global scale. Despite the increasing efforts to report such information, a review of the information revealed a need for greater comparability among different non-financial reporting frameworks (Cinquini & De Luca, 2022). In addition to the need for comparison, increasing demands and pressures have also begun to emerge from investors and other stakeholders. A larger set of information reduces risk to investors and improves the credibility of companies. Thus, it encourages sustainable corporate governance and increases trust in capital markets (Dobija et al., 2023). Therefore, the EU has adopted the NFRD which mandates certain companies (entities of public interest with more than 500 employees on their balance sheet day) to report non-financial information. The NFRD consists of two parts. The first part represents the diversity policy where the company discloses information on the composition of its management or supervisory board in terms of gender, education, and age (Belak & Primec, 2020). The second part of the reporting covers non-financial information from the perspective of environmental, social, employee-related, human rights, and anti-corruption and bribery aspects. NFRD was adopted in 2014, and companies had to report their first non-financial information in 2018 for the fiscal year 2017 (Primec & Belak, 2017).

For each of the above-stated matters, companies have to report (European Commission, 2019): 1) *"a brief description of the company's business model,* 2) *a description of the policies pursued by the company concerning those matters, including due diligence processes implemented,* 3) *the outcome of those policies,* 4) *the principal risks related to those matters linked to the company's operations, including, where relevant and proportionate, its business relationships, products or services which are likely to cause adverse impacts in those areas, and how the company manages those risks, as well as* 5) *non-financial key performance indicators relevant to the particular business.*

The companies report the data mentioned above based on the "comply or explain" principle which requires them to either disclose the specified data or explain any omissions. In 2020, the European Commission published findings from the review of the NFRD, highlighting that, based on the NFRD, companies have improved their governance towards sustainability by incorporating sustainable components into their governance. However, the NFRD research showed certain deficiencies, mainly related to the limited scope and clarity of reporting requirements, comparability of data, and the credibility and usefulness of reported non-financial information. These deficiencies were identified as obstacles and shortcomings in achieving the EU's sustainability goals (Parguel et al., 2011; Primec & Belak, 2022; Reddy, 2019).

To address the identified deficiencies of NFRD, the EU introduced the CSRD. Compared to the NFRD, the CSRD introduced several changes, such as increasing the scope of companies that are obliged to report sustainability information, more detailed and standardized reporting under ESRS standards, publishing information in machine-readable format, as well as digitally tagged, and penalties for non-reporting and reporting following the principle of double materiality. On the 5th of January, 2023, CSRD entered into force. Selected companies will be obliged to report following the CSRD starting from the year 2025 for the fiscal year 2024. It is expected that due to the new CSRD requirements, and especially due to standardized reporting based on the ESRS standards, the current level of information reporting will improve and address the above-mentioned shortcomings of the NFRD (Greiling & Bauer, 2023; Primec & Belak, 2022).

3 Discussion

A research model for researching the impact of NFRD and the CSRD on non-financial reporting was established, incorporating the criteria of NFRD, CSRD, and ESRS requirements. The research model identifies whether the aforementioned legislation requirements of NFRD and the CSRD impact the non-financial information reporting of companies in practice. In the research model, 3 ESG categories with 15 sub-categories were established for the following information groups:

- C1: Environmental group of information (comprised of 5 sub-categories),
- C2: Social group of information (comprised of 4 sub-categories), and
- C3: Governance group of information (comprised of 6 sub-categories).

The first group (C1) includes environmental information related to climate change, pollution, water and marine resources, biodiversity and ecosystems, and circular economy. The second group (C2) includes social information which defines whether companies reported information related to social factors which include the company's workforce, employees in the supply chain, other groups and local communities, and customers and end users. The third (C3) group explores information related to governance factors. In particular, it explores whether companies reported information related to the company's business model and strategies, management and quality of relations with business partners, corporate governance and supervisory board, products and services of the company, risk management and internal control, and responsible business practices. For each of the categories mentioned above, the following will be examined: 1) status of reported data (reported/not-reported), 2) comparability of reported data (companies' comparison with previous years' results), 3) forecast for future years (forecast of companies results for future years), 4) linkage of the non-financial data reported by the companies to companies financial reporting data, 5) integration of key stakeholders interests with sustainability topic, 6) definition of how risks, opportunities, or materiality of the sustainability topic may affect key stakeholders, 7) identification of main risks and opportunities in the sustainability area under review, and 8) indication double-materiality (considering financial materiality and impact materiality).

For the execution of the research, the most suitable companies will be those that are currently already obligated to report non-financial information following NFRD and will also be required to report non-financial information following CSRD in the coming years. Consequently, the research model will be most useful for fiscal years 2017 onward when companies were already required to report information following NFRD. More evident results, however, can be expected in 2025 (with the fiscal year 2024) when the first companies will begin to report following CSRD. The research will be conducted in two parts. The first part of the research involves the use of the research model, based on which the information reported by selected companies will be evaluated. Information will be obtained from companies' annual reports or sustainability reports. The multiple case studies method will be used, enabling the examination of specific cases or phenomena. This allows the researcher to gain detailed insights and understanding of the phenomenon. The method was chosen because it provides a thorough understanding of the circumstances and the situation under study (Primec & Belak, 2022; Yin, 2016). Based on the obtained results, categories will be formed and evaluated. Each category will be assessed within two time frames. In particular, it will be examined whether companies report information from the defined groups and sub-groups of the research model and whether the information is consistent with the requirements of the NFRD and CSRD. Based on the results obtained, a comparative analysis will be conducted in the second part of the research. In this part of the research, the results from both timeframes will be compared with each other. The level of reported information will indicate whether there has been an improvement in non-financial information reporting. Content analysis enables replicable and valid inferences to be drawn from the text. In addition, content analysis has been also used for similar research in the past (Nicolo et al., 2020). Based on the research results, it will be evident whether companies report the required information of the above-mentioned groups and sub-groups as set by the research model (Cinquini et al., 2022; Čufar et al. 2023, Nicolo et al., 2020).

Based on the conducted research, we expect to be able to answer the following questions about whether and how the NFRD and the CSRD legislation influence non-financial reporting in practice:

– evaluation of NFRD and the CSRD impact on the environmental group, particularly concerning content related to climate change, pollution, water and marine resources, biodiversity and ecosystems, and circular economy,

- evaluation of NFRD and CSRD on the social group, particularly concerning content related to the company's workforce, employees in the supply chain, other groups and local communities, and customers and end users, and
- evaluation of NFRD and the CSRD on the governance group, particularly concerning content related to the business model and strategies, risk management and internal control, products and services of the company, management and quality of relations with business partners, corporate governance and supervisory board, and responsible business practices.

Based on the results of the research using the mentioned methodology and research model, it will be apparent whether the requirements of NFRD and CSRD influence the level of non-financial reporting in practice. In particular, the results of the results will present whether non-financial information has improved since the adoption of NFRD and whether the upcoming requirements of CSRD had any impact on the level of non-financial reporting in practice. Based on the results of the research model, it will also be evident to what extent companies are already prepared for standardized reporting under ESRS standards and in which areas companies currently report the most information. The research model will allow a comparison of multiple non-financial reporting practices and their effect on sustainable corporate governance.

4 Conclusion

The paper brings additional insights into the field of non-financial reporting and sustainable corporate governance with the development of a research model that has been prepared based on the requirements of NFRD, CSRD, and ESRS. In particular, the research model measures how NFRD and CSRD impact non-financial reporting in practice. Additionally, the study aimed to showcase the importance and anticipated findings of employing the research model in future empirical surveys. For achieving companies' long-term success, sustainability and CSR must be implemented within the governance structures of corporations. Due to upcoming legislation changes, the research model will show the extent to which legislation currently affects non-financial reporting and the extent to which it is expected that reporting will change in the future. As a secondary method, interviews may be conducted with selected companies to get further insights.

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