An Economic Analysis and Review of Non-Financial Reporting in the European Union:

What Went Wrong with Directive 2014/95/EU

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Abstract Regulation of non-financial disclosure is a relatively new field of study. Thus far, scholars have mainly focused on understanding voluntary reporting. However, the rise of mandatory non-financial reporting around the world is opening new avenues of research. This study aims to contribute to the rising academic literature on the regulation of non-financial disclosure. First, an economic analysis of non-financial reporting regulation is conducted. Secondly, one of the first regulatory attempts in the field – the EU Non-Financial Reporting Directive (NFRD) – is investigated in light of the conducted economic analysis. Lastly, a brief forward-looking analysis of the 2021 revision of the NFRD – the Corporate Sustainability Reporting Directive (CSRD) – is also undertaken. This research provides insightful contributions to policymakers engaged in non-financial disclosure regulation by exploring potential future implications and laying the groundwork for empirical studies.

JEL classification: K20; M14; M48

Keywords: Sustainability, Accounting, Non-Financial Reporting, Mandatory disclosure, EU Directive

I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I acknowledge the supervision and guidance I have received from Professor Pierre Garello. This thesis is not used as part of any other examination and has not yet been published.

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List of abbreviations

CSR	Corporate Social Responsibility
CSRD	Corporate Sustainability Reporting Directive
EC	European Commission
EFRAG	European Financial Reporting Advisory Group
EU	European Union
GRI	Global Reporting Initiative
IFRS	International Financial Reporting Standards
NFRD	Non-Financial Reporting Directive
SEC	Securities and Exchange Commission

1 Introduction

1.1 Background and Problem Orientation

Corporate non-financial reporting – also known as sustainability reporting – has been around for quite a while, with the earliest examples of disclosure dating back to the 1970s (Ioannou & Serafeim, 2017). Over time, the number of companies reporting on sustainability matters has increased drastically. In 2020, around 80% of 5,200 N100[1] companies published a non-financial report against just 12% in 1993 (Threlfall, King, Shulman, & Bartels, 2020).

However, up until now, most of the academic research on non-financial reporting has focused on voluntary reporting (Grewal, Riedl, & Serafeim, 2019). Academic literature concerning the regulation of non-financial disclosure is still in its infant stage (Christensen, Hail, & Leuz, 2021), especially in the field of Law and Economics (Case, 2007). Over the last couple of years only, academics have started to research mandatory reporting and its regulation (e.g., La Torre, Sabelfeld, Blomkvist, Tarquinio, & Dumay, 2018; Jackson, Bartosch, Avetisyan, Kinderman, & Steen Knudsen, 2020; Monciardini, Mähönen, & Tsagas, 2020) As also evidenced by Fiandrino, Gromis, and Tonelli (2021) in their study, almost 60% of scientific literature on non-financial reporting was produced between 2019 and 2021.

The reason is that in most jurisdictions non-financial reporting has thus far been mainly a voluntary phenomenon, with no binding requirements imposed by the law (Monciardini et al., 2020). Nevertheless, in the last decade there has been a change in direction. More and more countries have been implementing some form of mandatory non-financial reporting (e.g., Van der Lugt, van de Wijs, & Petrovics, 2020). Especially in Europe, a few Member States started to implement national non-financial reporting policies, such as Denmark (i.e., CSR Reporting Law from 2009), France (i.e., Loi Grenelle I from 2010), and The United Kingdom (i.e., the Modern Slavery Act from 2015). Following this trend, in 2014, the European Union adopted the Non-Financial Reporting Directive (NFRD),

[1] The N100 comprises the largest 100 companies in 52 countries (Threlfall et al., 2020).

introducing for the first time a requirement for mandatory non-financial reporting at the European level.

1.2 Aim of the Research and Research Questions

This research endeavors to add up to the rising academic literature on the regulation of non-financial disclosure. On the one hand, it does so by undertaking an economic analysis of the regulation of corporate non-financial disclosure at the theoretical level. On the other hand, it applies the results of this analysis to one of its first real-life implementations, the NFRD. To the best of our knowledge, no previous study on the NFRD adopted such an approach. This analysis is especially important in light of the European Commission (EC) commitment to revise the NFRD as communicated in the European Green Deal (European Commission, 2019a) and its 2020 Work Programme (European Commission, 2020a). Academic studies can indeed provide regulators with insightful contributions for the development of non-financial disclosure regulation (Garcia-Torea, Larrinaga, & Luque-Vílchez, 2020). Furthermore, the recent proposal on the update of the NFRD put forward by the European Commission in April 2021 – the Corporate Sustainability Reporting Directive (CSRD) – allowed this research to include a brief forward-looking analysis of the proposed changes.

In particular, this research aims to explore and answer the following research questions:

RQ1: From a Law and Economics perspective, should non-financial reporting be regulated?

RQ2: Was the NFRD a fully successful attempt?

RQ3: Will the CSRD (as proposed) be the solution?

1.3 Methodology

First, a Theoretical Framework is developed mainly by reviewing existing financial disclosure literature while keeping in mind the peculiarities of non-financial disclosure. As evidenced by Korca and Costa (2020), few studies on non-financial reporting – particularly on the NFRD – have followed a theoretical approach. Therefore, this research employs economic theory to support the interpretation of findings. Secondly, the analysis of the NFRD is conducted in light of the Theoretical Framework and supported by relevant data coming from Public Consultations and independent reports and studies. Lastly, based on the same Theoretical Framework, the 2021 CSRD Proposal will be investigated, trying to shed some light on potential future implications for the objective and very existence of the Directive itself.

2 Theoretical Framework – Regulation of Non-Financial Reporting: An Economic Analysis

This Chapter contains an economic analysis of the regulation of non-financial information, mainly based on findings from the financial reporting literature. Nowadays, investors increasingly rely on non-financial information for their investment decisions (e.g., Cheng, Ioannou, & Serafeim, 2014; Eccles, Serafeim, & Krzus, 2011; Ioannou & Serafeim, 2015). Indeed, what is relevant for society (i.e., environmental and social issues) is often relevant for investors because of the financial backlash that society's discontent may cause (e.g., consumer boycotts) or of the existence of the company itself in the future (e.g., availability of raw materials). Therefore, it is reasonable to apply some of the prior findings from the financial reporting literature while considering the typical features that distinguish non-financial disclosure (Christensen, Hail, & Leuz, 2019).

2.1 A Definition

Non-financial reporting – also known as Corporate Sustainability Accounting (CSA), Corporate Social Responsibility (CSR) reporting – consists of the disclosure of the social and environmental impacts of a company's activities (and often of a company's actions to mitigate them) as part of the financial report or as a separate stand-alone report. The term has been clearly described by Gray, Owen, and Maunders (1987, p. ix) as:

"*Communicating the social and environmental effects of organizations' economic actions to particular interest groups within society and to society at large. As such it involves extending the accountability of organizations (particularly companies), beyond the traditional role of providing a financial account to the owners of capital, in particular, shareholders.*"

2.2 Historical Background of Non-Financial Reporting

The first studies on non-financial reporting date back to the 1940s. The precursors of this field were Theodore J. Kreps and Howard R. Bowen (Carroll & Beiler, 1975; Hess, 2008). Kreps was the first one to research how to measure companies' contributions to the goals of our economic system, which go beyond the achievement of profit. Bowen developed a system for outside auditors to measure companies' performance of social matters and pled for the external use of this audit information.

However, it is just in the 1970s that companies started to face increased criticism for the negative environmental and social impact of their activities. The first wave of non-financial reporting was initiated by U.S. and Western European companies, driven by a renewed awareness of social and environmental accountability (Ioannou & Serafeim, 2017). The trend grew stronger in the 1990s with the rise of multinationals and protests against the effects of globalization (Kolk, 2003). Shortly after, Governments and NGOs' – such as the Global Reporting Initiative[2] (GRI) – started to involve themselves by providing recommendations and developing guidelines to facilitate voluntary reporting. In more recent years, with increasing social and environmental challenges, companies are even more pressured to disclose how they affect natural resources and society. For instance, demand for non-financial reporting is coming from investors, who recently began to integrate ESG data in their valuation models (Ioannou & Serafeim, 2015).

2.3 Differences with Financial Reporting

To analyze non-financial reporting regulation starting from the financial reporting literature, it is important to keep in mind the core differences between the two. The following key elements characterize non-financial versus financial reporting:

1. *Multidimensional content*: while financial reports contain only the financial data of a company, non-financial reports may encompass a wide range of topics. In general, it is possible to distinguish between environmental and social activities, but topics usually differ across companies, industries, and countries. For example, greenhouse gas emissions are the main concern for energy producers, but likely less fundamental for financial institutions. Consequently, CSR activities are hardly measurable in monetary terms and the same activities may be measured according to different metrics (Kitzmueller & Shimshack, 2012).
2. *Audience and usage diversity*: while financial information is – in principle and in virtue of its quite complicated nature – mainly addressed to shareholders and potential investors, the audience of non-financial information is wider, comprising

[2] The Global Reporting Initiative (GRI) was launched in 1997 by the Coalition for Environmentally Responsible Economies (CERES) and the United Nations Environment Program (UNEP) with the goals of developing and establishing reporting guidelines for the economic, environmental and social performances by companies.

entities such as NGOs, consumers, labor unions, and so forth (e.g., Christensen, Hail, & Leuz, 2021). Furthermore, non-financial information can be used for a multitude of purposes (e.g., to check coherence between a reader's ethical values and the policies implemented by a firm) and not simply as a complement of financial information within the financial analysis of a company. Therefore, the use of disclosed non-financial information by others than capital market participants could generate indirect costs for the reporting firm (e.g., Verrecchia, 1983)

3. *"Longer"-term oriented*: non-financial information has a more forward-looking perspective than financial information (Kaplan & Norton, 1992). It takes into consideration issues that may be core for the long-term future viability of a company – such as consumer goodwill or the availability of essential raw materials in the future – that are harder to quantify.
4. *Mostly not legally binding*: non-financial reporting is still widely undertaken as a voluntary practice. In many countries, companies of all sizes and sectors are encouraged to produce non-financial reports to understand and inform stakeholders about the impact of their activities. However, a mandate is still not enforced in all countries. In 2020, 84 countries had around 600 non-financial reporting instruments, and 60 % of those were mandatory (Van der Lugt et al., 2020). Furthermore, there is no global consensus on a single set of standards[3].

2.4 Regulation of Non-Financial Reporting:

2.4.1 Market failures

According to the Public Interest Theory, typically associated with Arthur C. Pigou (1920), regulations[4] are implemented for the benefit of the public at large (Hantke-Domas, 2003). Regulations should aim to reaching a Pareto-efficient allocation of resources in society, namely a situation where no individual can be made better off without making at least

[3] Many standards and guidelines have been developed in the last decades. Among the most commonly known frameworks are the following: the Global Reporting Initiative (GRI) Standards, the United Nations (UN) Global Compact Principles, the Organizations for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises (MNEs), and the International Standard Organization`s Guidance on Social Responsibility (ISO26000).

[4] For the purpose of this thesis, regulation is defined following the Organization for Economic Co-operation and Development (OECD) definition as the imposition of (disclosure and reporting) rules by a central authority (Khemani & Shapiro, 1993).

another individual worse off. In other words, and as stressed by the "Chicago" critique of the Public Interest Theory (Coase, 1960), regulations should be implemented *solely* to correct market failures. Market failures happen when the price mechanism of a free market is distorted, leading to a Pareto-inefficient allocation of goods and services and the following loss of welfare.

There are four types of market failures: information asymmetries, externalities, market power, and public goods. When discussing whether to impose regulations for the disclosure of non-financial information, it is important to analyze if market forces – supported by property rights, contract law, and impartial courts – can obtain optimal levels of disclosure without regulation, and, if not, which one is the market failure creating scope for regulation (Bushman & Landsman, 2010). The following subsections will discuss what has been typically defined as market failures for financial disclosure and apply it to non-financial disclosure and identify which market failures (if existent) could be typical of non-financial disclosure.

2.4.1.1 Information asymmetries: adverse selection and moral hazard

Information asymmetry arises when one party to a transaction has greater knowledge than the other one. Corollary problems of information asymmetries are the adverse selection and moral hazard problems (Akerlof, 1970; Jensen & Meckling, 1976)[5].

Advocates of regulation for financial disclosure usually argue for the existence of information asymmetries and for the role of corporate reporting to mitigate them (e.g., Cooper & Keim, 1983). Information asymmetries arise between companies and investors, and among informed and less-informed investors. The most supported benefits by the theoretical and empirical literature coming from the regulation of information disclosure are increased market liquidity[6] and the reduction of the cost of capital. These benefits are

[5] Adverse selection is an *a priori* problem (i.e., before a transaction takes place) and it involves one party not knowing certain information about the other party. For example, an insurance company unaware if a certain potential buyer is a high or low-risk one. Consequences of this are higher overall prices, high costs for the seller to try to identify customer groups, and the possibility of a missing market (i.e., customers leaving the market). On the contrary, moral hazard is a *a posteriori* problem (i.e., after a transaction takes place) and it concerns missing information over the actions of one party. For example, an insurance company not knowing if its customers are behaving responsibly or not. A consequence of moral hazard is the increased cost of control.

[6] i.e., a situation where investors can quickly buy or sell assets without having a drastic impact on the asset's price.

usually labeled as “firm-specific,” as they translate into direct benefits for the firm engaging in disclosure (Leuz & Wysocki, 2008).

Corporate disclosure can increase market liquidity by *“leveling the playing field”* among investors (Verrecchia, 2001; p. 173). Without corporate disclosure, there are less informed and more informed investors in the capital market. Less-informed investors will be afraid of trading with better-informed investors because they fear a more-informed investor will be willing to sell an asset at the market price only when they know – relative to the information they possess – that the asset is currently overpriced, and vice versa for the buying situation (e.g., Glosten & Milgrom, 1985). Therefore, less-informed investors will eventually lower their reservation price for the asset or exit the market not to incur potential losses. With mandated corporate disclosure, the consequences of this adverse selection are mitigated.

The second benefit comes from reducing the cost of capital for firms (e.g., Leuz & Wysocki, 2016). First, the aforementioned increase in market liquidity contributes to the reduction in the cost of capital. Illiquidity and strong differences between bid and offer prices raise transaction costs for investors for which they expect to be compensated at equilibrium (e.g., Amihud & Mendelson, 1989; Constantinides, 1986; Leuz & Wysocki, 2016). Secondly, the cost of capital is also reduced by the improved risk-sharing in the economy generated by the increased awareness of investors over which assets to hold (e.g., Diamond & Verrecchia, 1991; Leuz & Wysocki, 2016; Merton, 1987). Lastly, disclosure of financial information reveals a firm’s value and therefore lowers estimation risk and cost for investors, eventually decreasing the cost of capital for firms (Brown, 1979; Lambert, Leuz, & Verrecchia, 2011; Milgrom & Roberts, 1986). In other words, without information, skeptical market agents would assume something is wrong with the company and lower its valuation.

Besides, it is worth mentioning another benefit coming from the reduction in information asymmetry between a company and investors. Financial reports can help the corporate governance process by changing managerial incentives. In modern society, the separation of ownership (i.e., investors) and management in companies has created a need for accountability (Watts & Zimmerman, 1983). On the one hand, investors delegate decision-making authority to managers, but they cannot observe managers’ actions. On the other hand, managers themselves have self-interests that often do not coincide with investors’ best interests. Mandated disclosure triggers reduction of potential opportunistic behaviors by managers (i.e., moral hazard) – such as avoiding the disclosure of information that would lead to their dismissal – and in general better managerial decision-making (e.g., Bushman & Smith, 2001).

The same arguments – i.e., increased market liquidity and reduced cost of capital – can be put forward also for non-financial information, as nowadays investors rely on it for their investment decisions (e.g., Ioannou & Serafeim, 2015).

An additional point to make is that financial disclosure has to be credible (e.g., Hope, Thomas, & Vyas, 2011). This is the reason why a regulation on financial disclosure, in the vast majority of cases, mandates the audit[7] of the information provided, as the aforementioned managerial incentives to provide truthful information coming from simple disclosure may not be enough. The economic reasoning behind an audit requirement lies in the information asymmetries and differing motives that arise in a principal-agent relationship. For example, because of financial rewards or fear of dismissal, managers may decide to disclose better-looking financial information rather than the real one. This situation generates trust issues on the investors' side, which will try to put in place monitoring mechanisms, among which an external control of the information provided.

Concerning non-financial information, the same problem arises. Empirical studies demonstrated that the credibility of non-financial reports is higher when it is assured especially because of its discretionary nature (e.g., Pflugrath, Roebuck, & Simnett, 2011). Likewise, some authors claim that assurance of non-financial information could be even more decisive than for financial one (e.g., Christensen et al., 2019). The literature reports that, as much as managers may have an interest in making a company appearing financially sounder than it actually is, they may also have an incentive to portray it as more sustainable (e.g., Cho & Patten, 2007; Wagner, Lutz, & Weitz, 2009). Therefore, it can be argued that without the performance of an audit check, some of the benefits coming from a mandate of non-financial disclosure may be lost, as information asymmetries would not be solved.

However, some studies demonstrated that, even without a clear audit mandate, the imposition of non-financial disclosure leads to the creation of a CSR assurance market.

[7] The audit process refers to the examination and certification of financial records by an independent entity.

For example, Ioannou and Serafeim (2017) uncovered that after introducing mandated non-financial reporting standards, companies voluntarily searched for assurance to increase credibility and distinguish themselves from firms engaging in "greenwashing" practices. Therefore, it is hard to define *a priori* and without further empirical studies whether a non-financial reporting mandate should come with an audit mandate or not.

To sum up, disclosure of financial (and non-financial) information – especially if strengthened through an audit requirement – may lead to increased market liquidity, reduced cost of capital, and better managerial decision-making. However, these benefits do not justify a *per se* mandate. If the benefits of disclosure are higher than the related costs (e.g., the cost of drafting the reports, the cost of disseminating key information, etc.), companies will have an incentive to provide this information (e.g., Ross, 1979). As clearly explained by Leuz and Wysocki (2008), without companies disclosing their private information, investors are not able to distinguish between worthy and unworthy companies. Therefore, worthy companies have an incentive to provide investors information about their true value, as they are the ultimate cost-bearer for withheld information. Investors will then rationally infer that non-disclosing companies have an average lower value and reduce the price they are willing to pay for them. Consequently, non-disclosing firms with a value above this newly established price will have an incentive to disclose, and so on. Considering all the above, another market failure than just information asymmetry may be needed to justify intervention.

Nevertheless, for what concerns especially non-financial reports, it is important to mention one benefit that may come from an official mandate. A mandate may serve to avoid the use of boilerplate language[8] and to facilitate the production of material information[9] for the firm at hand. In particular, for non-financial reporting, it is often the case where companies provide optimistic and self-promoting qualitative disclosure (i.e., "green glossy" reports) just to conceal valuable information to investors (e.g., Michelon,

[8] "Standardized disclosure that is so prevalent that it is unlikely to be informative" (Lang & Stice-Lawrence, 2015; p. 113).

[9] In traditional accounting, the International Accounting Standards Board (IASB) defined material information as that information that if omitted, misstated or obscured "it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements" (IFRS, 2018; p. 1). In non-financial reporting, material information has been defined by the GRI Standards as "those topics that reflect the reporting organization's significant economic, environmental, and social impacts or substantively influence the assessments and decisions of stakeholders" (GSSB, 2020; p. 10).

Pilonato, & Ricceri, 2015). The provision of mandatory standards (e.g., industry-specific standards, quantitative metrics) may help solve the problem.

Nevertheless, the literature about reporting incentives (e.g., Christensen, Lee, Walker, & Zeng, 2015; Leuz, 2010) points out that mandated standards may still have a limited role in avoiding the production of uninformative reports. A regulation of non-financial information needs to leave enough discretion to firms because of CSR's multidimensional nature and topics. Indeed, it is challenging to define what information is material and to whom when it comes to non-financial information. Given this needed flexibility in reporting, firm-specific (e.g., capital needs) and managerial incentives (e.g., compensation schemes) may influence the disclosure of private information. So, even with a mandate, there is the risk that the information provided with disclosure could still be uninformative. Also, it is interesting to note how the use of boilerplate language may signal the elevated cost of compliance for companies.

2.4.1.2 Negative externalities: detrimental social and environmental effects

One market failure that is sometimes presented as a justification for the regulation of non-financial reporting is negative externalities (Albertini, 2014; Maas & Sampers, 2020; Young & Marais, 2012). A negative externality is a cost imposed by the activity of one party on an unrelated third party (Morgan, Katz, & Rosen, 2006; Pigou, 1920). Firms impose negative externalities on society when, through their economic activities, they damage natural resources or act against society's welfare.

In order to achieve a Pareto-efficient allocation of resources, negative externalities need to be internalized. Nowadays, firms themselves are increasingly engaging in spontaneous CSR activities intended to alleviate their negative externalities on society. However, voluntarily CSR activities often do not fully address social costs, as firms internalize externalities only as long as the internalization is not detrimental, but rather neutral or beneficial for financial performance (e.g., Amaeshi, 2010; Orlitzky, 2011). Therefore, according to economic thought, there are two viable solutions to the problem of negative externalities: regulatory instruments, such as a Pigouvian tax (Pigou, 1920), or Coasian bargaining between the injurer and the victim of the externality (Coase, 1960). Social and environmental issues often involve high information asymmetries, a multitude of victims dispersed in time and place, high transaction costs, and risk of opportunistic behavior. Therefore, bargaining between the parties is impeded, leaving room for regulation. This reasoning is the so-called *normative* interpretation of the Coase theorem, which has usually been taken as a basis for developing public policies aimed at reducing transaction costs (Cooter, 1982; Cooter & Ulen, 2008).

According to the existing literature, transparency requirements in terms of environmental and social impacts seem to generate more socially and environmentally responsible decision-making (e.g., Halter, de Arruda, & Halter, 2009). A regulation that makes non-financial reporting mandatory is likely to increase commitment towards CSR activities (e.g., Albertini, 2014; Young & Marais, 2012). For example, Jackson et al. (2020) demonstrated through an empirical study that mandatory non-financial reporting leads to an increase in the amount of CSR activities and that the largest impact is on firms with previously lower levels of CSR. After the introduction of such regulations, benchmarking against competitors seems to at least partly drive this increase. Thanks to mandated rules, companies can more easily make comparisons with competitors – and avoid performing worse than them – and promote discussions about best practices (Fiechter, Hitz, & Nico, 2018; Russo-Spena, Tregua, & De Chiara, 2018).

However, regulation is a costly effort, and its effects should be as efficient as possible. Justifying a regulation of non-financial disclosure with negative externalities seems a bit far-fetched. One positive side effect of disclosure regulation is indeed the alleviation of negative externalities caused by businesses. However, this should not be its primary aim but rather a secondary one. Theoretically, it can be argued that there are better and more efficient mechanisms that directly deal with the production of negative externalities (e.g., Kennedy, Laplante, & Maxwell, 1994). They are broadly classified in regulatory (e.g., "command-and-control" regulations, such as pollution limits) and market-based (e.g., "caps and trade," like the EU Emissions Trading System) instruments. Regulation of information disclosure amplifies traditional regulatory tools by creating third-party monitors by stakeholders – especially investors – and incentives (Kleindorfer & Orts, 1998). A regulation of non-financial disclosure is an "*imperfect substitute*" of traditional instruments and rather works as a complement to them (Case, 2007, p. 7; Tietenberg, 1998). Therefore, even while considering the positive effect towards the internalization of negative externalities, another market failure is needed to justify the regulation of non-financial disclosure.

2.4.1.3 Positive externalities: market-wide cost savings and spillover effects

Prior theoretical and empirical studies provide evidence of positive externalities linked to firms' disclosure of information in a variety of situations. This result is important because, when defining their optimal level of disclosure, firms will not consider the benefits provided to the market or other stakeholders, causing underinvestment in those benefits. Therefore, these positive externalities could provide a justification for regulatory intervention.

Firstly, having access to financial reports that are easily comparable (i.e., following the same standards and metrics) creates benefits for investors and other stakeholders by reducing their transaction costs (Christensen, Hail, & Leuz, 2019). Indeed, comparable reports make it easier and less costly to draw parallels between firms and they eventually enable the market to reach a Pareto-efficient allocation of resources. For example, the adoption of the International Financial Reporting Standards (IFRS) increased cross-border investments by increasing comparability among financial reports (DeFond, Hu, Hung, & Li, 2011). However, when undergoing an individual cost-benefit analysis of whether or not to disclose its private information, a firm will not consider these market-wide cost savings. In other words, it will not take into account the positive externalities stemming from the coordination of firms' reporting choices at the aggregate level. A result of this is general underinvestment in more comparable disclosures. The same reasoning can be transposed to the domain of non-financial disclosure. As of today, there are numerous standards that companies could use to report non-financial information[10]. Therefore, a regulation that mandates a specified set of standards and metrics to follow at the national or supranational level could make firms internalize the positive externality coming from harmonization and could therefore be justified, as long as this benefit is higher than the costs of it.

However, it is important to mention that, according to existent literature, formal harmonization through normative rules does not necessarily lead to practical harmonization, as rules may still be followed in uneven ways by companies as long as they are given enough discretion. For example, as presented in a study by Chauvey, Giordano-Spring, Cho, and Patten (2015), the movement of non-financial disclosure

[10] See supra note 3.

requirements towards normativity in France did not lead to an increase in information quality and comparability.

Regulation could also bring other economy-wide cost savings. As demonstrated for financial information, a mandate on the disclosure of non-financial information would eliminate the duplicative effort of collecting information on the side of investors (Bushman & Landsman, 2010; Coffee, 1984). Namely, it would avoid the costs of having every single investor transact with each company to obtain information. Also, it would allow the information to be produced by the lowest cost producer (i.e., the company), rather than having capital market participants search for the information themselves. This is in line with the argument put forward by Hirshleifer (1978). The search of private information for speculative gains in capital markets simply creates a transfer of wealth, thereby being a pointless waste of resources for society.

Moreover, financial disclosure has been shown to generate also spillover effects on other companies (Admati & Pfleiderer, 2000; Dye, 1990). Even though the individual contribution of every single company is likely to be small, this information in the aggregate can be valuable for other companies and for the investors evaluating those other companies (Bushee & Leuz, 2005). Disclosure by one company could indeed provide information about common economic factors (e.g., demand, supply, cost structure, etc.), technological innovation, governance structures, and so forth, to other companies. For example, Shroff, Verdi, and Yu (2014) demonstrated that disclosure coming from peer firms reduces agency problems between a parent company and its foreign subsidiaries by better informing the parent company about the economic environment of the subsidiaries.

2.4.2 Regulation as a solution?

In brief, disclosure of non-financial information could help solve information asymmetry problems and internalize negative and positive externalities. Concerning information asymmetry, the solution of adverse selection and moral hazard problems translates into increased market liquidity, lower cost of capital, and better managerial decisions. However, information asymmetries are not enough to justify regulation. Firms will have an incentive to provide the information as long as its benefits are higher than the related costs. Concerning negative externalities, a disclosure mandate for non-financial information has proven to reduce negative externalities produced by firms. However, an information regulation can only act as a complement to traditional regulatory tools.

Indeed, there are better policies – often already in place – specifically aimed at making firms internalizing the negative externalities they produce. Therefore, the most important benefit of a non-financial reporting regulation could come from the internalization of positive externalities – i.e., market-wide cost savings – created for example by the harmonization of reporting practices.

2.4.2.1 The costs of regulation

However, even if empirical results could prove that the benefits coming from market-wide cost savings due to a mandate are substantial, market failure alone is not sufficient to justify regulation. In order to avoid the "*Nirvana fallacy*" (Demsetz, 1969, p. 1), it is essential to recognize that regulations come at a cost and not without problems. In other words, the potential benefits will have to be benchmarked with the potential costs arising from regulation.

First of all, regulation of non-financial disclosure brings about costs for the regulated entities that need to be carefully assessed. If disclosure is not efficient at the firm level (i.e., the costs are perceived as higher than the benefits for the individual firm), it will need to be justified by positive impacts on the general social welfare. It is possible to distinguish firm-specific costs into three categories: execution, proprietary and political costs. Execution costs relate to data collection, preparation, and dissemination of non-financial information. They usually depend, among other factors, on the size of the company, the comprehensiveness of the disclosure, and the level of assurance provided. In particular, such costs are expected to be higher the first year of reporting. If a mandate for non-financial disclosure is introduced, firms who did not provide this information voluntarily beforehand will likely face a negative cost-benefit tradeoff (e.g., Grewal, Riedl, & Serafeim, 2019). Proprietary costs were defined for the first time by Verrecchia (1983). They are costs incurred by a firm because of its obligation to disclose what may be business-sensitive information to a wide variety of stakeholders, possibly harming its competitiveness. This problem seems to be especially relevant for non-financial information, as it is often directly linked to the core operations of a firm (e.g., resources used, employee relations, etc.), and may be a window to its weaknesses (Christensen et al., 2019). Lastly, political costs can be defined as the potential costs deriving from governmental and interest groups' pressures that may arise from the higher availability of corporate information (Watts & Zimmerman, 1978).

Secondly, defining and implementing regulations is costly. To start with, the drafting of the regulation itself takes up many resources. Information needs to be gathered, policy options need to be listed and evaluated, and the regulation needs to be written. Also, it is essential to point out that individual firms often have an informational advantage. They can acquire information at a lower cost than a central regulator and are better informed about the costs and benefits of their own disclosures. In addition, the implementation phase gives rise to administrative, monitoring, and enforcement costs (Marneffe & Vereeck, 2011). Besides, a regulation can quickly become outdated and the constant need of updating regulations results in the loss of resources. This is especially significant in the realm of non-financial information, where definition and stakeholders' interests are rapidly changing (Christensen et al., 2019). Furthermore, regulators may be "captured" by interest groups through lobbying efforts and political contributions (Stigler, 1971). Regulations may in this case be enacted to serve private interests rather than the public one. For example, to hinder competition, incumbents tend to oppose disclosure regulations that may help new entrants raise capital more easily (e.g., Rajan & Zingales, 2003).

Moreover, an important hidden cost of disclosure regulation that is often overlooked is the "*accumulation problem*" (Ben-Shahar & Schneider, 2015, p. 256). Each disclosure takes a bit of people's attention, causing an information overload and reducing the effectiveness of other disclosures. However, this negative externality of regulation – which depends on the number of disclosure individuals get – will not be taken into account as disclosures are regulated one by one and not in a comprehensive way (*ibidem*). Furthermore, even if recognized, the accumulation problem would be extremely hard to quantify. Also, the (positive or negative) interactions with other kinds of regulations (i.e., different than disclosure ones) are hard to quantify.

2.4.2.2 Possible alternatives

When considering the costs and benefits of a regulation, it is only natural to think about its possible alternatives. Disclosure regulation by the government is already considered a *"light-handed"* type of regulation (Hepburn, 2006, p. 7) because governmental influence over people's decision-making and behavior is limited. A viable alternative would be to simply let the market be. This solution should be adopted in the case where regulatory costs (or possible failure) are deemed higher than the costs coming from the market failure itself. However, this hypothesis is hardly taken into consideration by regulators. As exemplified by George Stigler – and reported by Voigt (2019) – it is as if during a musical competition between two pianists, the second one (i.e., governmental intervention) is crowned the winner without even having to play because the first one who played (i.e., market failure) was deemed to be just terrible. But what if the second player is even worse than the first one?

2.4.3 Final remarks

In conclusion, a case in favor or against regulation of non-financial reporting is hard to define *ex-ante*. Among the benefits that regulation of non-financial reporting is supposed to achieve (namely, solving information asymmetries and internalizing negative and positive externalities), the internalization of positive externalities (i.e., the harmonization of disclosures) seems the most justifiable one. Nevertheless, regulatory policies come at a cost for both the regulated entities and the regulator himself and should not be treated lightly.

In general, the benefits coming from the disclosure information are often so praised that are *assumed* to be higher than the costs of mandates (Ben-Shahar & Schneider, 2015). However, all potential benefits of a non-financial disclosure mandate need to be compared with its potential costs, as much as possible. For this purpose, theoretical analysis (like this research) and the combination of many different empirical studies, such as Cost-Benefit Analysis (CBAs), should be developed to support truly informed decision-making at the regulatory level. In the end, regulators have to ask themselves whether the net benefits (or costs) coming from interventions in non-financial disclosure are higher (or lower) than the costs of the market failure itself.

3 Backward-looking Analysis – Non-Financial Reporting in the European Union: Directive 2014/95/EU

This Chapter is an attempt to analyze whether the Non-Financial Reporting Directive (NFRD) was a successful regulatory attempt. First, a summary of the main provisions of the Directive is presented. Secondly, the regulatory approach taken by the EU legislator is analyzed in light of the Theoretical Framework of Chapter 1. The analysis is supported by relevant data coming from Public Consultations and independent reports and studies. Lastly, it is questioned whether the legislative decisions taken by the EU legislator could possibly be justified from a Law and Economics perspective, keeping in mind that the NRFD is one of the first regulatory attempts in the domain of non-financial reporting.

3.1 The Non-Financial Reporting Directive (NFRD)

3.1.1 Overview

The Non-Financial Reporting Directive (Directive 2014/95/EU, hereafter identified as "NFRD") entered into force in 2014, amending the Accounting Directive (Directive 2013/34/EU). In general terms, it requires large companies to publish a regular non-financial statement on the social and environmental impacts of their activities. As a Directive, according to Article 288 of the Treaty on the Functioning of the European Union (TFEU), the NFRD constituted an attempt of minimum-harmonization and thus left the Member States some degree of freedom in national transpositions. The Member States were required to transpose the Directive into national law before 2016. As per Article 4 of the NFRD (2014), the first fiscal year to be subject to the NFRD requirements was 2017, leading to three years of reporting under the NFRD until 2020.

3.1.2 Aim

In its Consultation prior to the drafting of the NFRD, the EC (2011) highlighted that non-financial information in the EU was scarce in terms of quantity, quality, and comparability. In particular, it was underlined a general lack of transparency and understanding of companies' CSR policies. For instance, at that time, companies' disclosures dealt mostly with their positive impacts rather than the negative ones (e.g., European Commission, 2011; Neu, Warsame, & Pedwell, 1998). The objective of the NFRD, as stated in the

Directive itself (NFRD, 2014 Recital 21, p. L 330/4), was *"to increase the relevance, consistency, and comparability of information disclosed by certain large undertakings and groups across the Union"*, in order to serve mainly two aims. On the one hand, as shown in the Directive itself and its first Impact Assessment document (European Commission, 2013), the EU legislator saw the regulation of non-financial disclosure as necessary to facilitate informed investment decisions, increase investors and consumers' trust in markets and provide for a better capital allocation. On the other hand, such a Directive was seen as instrumental *"for managing change towards a sustainable global economy"* (NFRD, 2014, Recital 3, p. L 330/1), namely, to increase companies' commitment towards CSR activities, by increasing the monitoring of companies' performance and impact on society[11].

3.1.3 Scope, subject matter, and mode of disclosure

Subject to the NFRD requirements are those large undertakings identified as "*public interest entities*" (i.e., large listed companies, banks, insurance companies, and those other undertakings recognized by national authorities as public-interest entities) with more than 500 employees (NFRD, 2014, Article 1(1), p. L 330/5). According to the figures provided by de Groen et al. (2020) in their report for the EC, the NFRD covered approximately 11.500 undertakings and groups of undertakings across the EU.

According to the Directive, companies are required to provide information relating to, as a minimum, environmental, social and employee matters; respect for human rights; anti-corruption and bribery matters; board diversity. Furthermore, undertakings have to provide information about their business model; policies put in place, due diligence processes and outcomes of those policies; principal risks and related risk management practices; and non-financial Key Performance Indicators (KPIs) (NFRD, 2014, Article 1(1)).

The NFRD gives companies a generous amount of flexibility on *what* to report. Information should be included *"to the extent necessary"* for stakeholders to understand the undertaking's *"development, performance, position and impact"* of its activities (*ibidem*). This is the so-called "double materiality" principle: companies have to disclose

[11] See also the EC's communication "A renewed EU strategy 2011-14 for Corporate Social Responsibility" (2011), where the disclosure of non-financial information is seen as an instrumental tool for the creation of a comprehensive CSR policy.

how sustainability issues may affect the future of the company and how the company itself, through its activities, affects society. Moreover, the NFRD makes use of a "comply-or-explain" approach: the undertaking can avoid implementing policies (and therefore disclose information about them) to address one or some of the above key matters, but it has to provide a *"clear and reasoned"* justification for doing so (*ibidem*).

Also, in terms of *how* to disclose non-financial information companies enjoy a certain degree of freedom. There are no EU-mandated standards, and no single existing national or international framework was mandated. Instead, companies may rely on national, Union-based, or international frameworks, or even create their own reporting framework by integrating existing guidelines (*ibidem*). Furthermore, undertakings are not obliged to publish non-financial information in the management report but have the chance to provide a sustainability report, published along with the management one or at a maximum of six months after it (NFRD, 2014; Article 1(4)).

Lastly, as a compliance mechanism, the NFRD provides for formal verification of the provided information. It is stated in Article 1(5) that a statutory auditor or audit firm has the duty to check whether non-financial information has been provided or not. However, it is up to the Member States to decide whether to have the reported information be verified – in its content and form – by an independent auditor (NRFD, 2014; Article 1(6)).

3.2 A Review of the European Union's Regulatory Approach

In this Section, an economic analysis of the NFRD's ability to achieve the relevant benefits of a non-financial reporting regulation – as evidenced in Chapter 1 – is conducted. Next, a brief overview of the main costs behind the NFRD is presented.

3.2.1 Achievement of the primary benefits of non-financial disclosure regulation

This section first analyzes whether the NFRD generated those benefits, identified in the Theoretical Framework, that could legitimate its existence [12] : informativeness, harmonization and reliability of disclosure. The analysis is conducted by using available data mostly coming from Public Consultations, independent reports and studies. Secondly, potential reasons behind the failure or success of the Directive in achieving each of the benefits are investigated.

[12] N.b. if higher than the related costs.

3.2.1.1 Informativeness of disclosure

As evidenced in Chapter 1, non-financial information regulation can help to reduce the production of uninformative disclosure and boilerplate terminology. However, as pointed out by the reporting incentives literature, even with a mandate, the informativeness of disclosure may boil down to company and managerial reporting incentives. This is particularly true in the case of a non-prescriptive and flexible regulation, such as the NFRD. The NFRD \is characterized by extensive use of vague formulations which are in some cases explained and further developed just in non-binding Guidelines[13] (European Commission, 2017; 2019b). For example, in Article 1(1) of the NFRD (p. L 330/5), it is stated that the non-financial report should contain information "*to the extent possible*" to understand a company's performance and impact. Further ahead in the same Article, it is indicated that certain principal risks relating to a company's operations should be included "*where relevant and proportionate*," and that non-financial KPIs which are "*relevant*" to a particular business should be used. All of these fuzzy formulations favor cherry-picking by companies and managers, who may decide to disclose non-material information and/or to provide uninformative reports solely to be compliant (i.e., as a "box-ticking" exercise). As a result, according to the recent Public Consultation conducted by the EC (2020), 72% of users[14] of non-financial reports stated that under the NFRD companies are not disclosing all relevant information and in particular just a minority (26%) believes that the level of information provided is sufficient for the financial sector. Furthermore, the "comply-or-explain" approach gives even more of a bigger chance to just omit reporting relevant information. This principle is similar to the one introduced by Directive 2006/46/EC in the Corporate Governance field[15] (Szabó & Sørensen, 2015). Evidence put forward by several studies proved that this "comply-or-explain" principle was not so successful. For instance, according to a study conducted by RiskMetrics Group (2009), 61% of explanations for non-compliance to the relevant

[13] As required per the Directive, the EC published a first set of Guidelines in 2017 to support companies in their reporting effort and help them understand what is demanded of them, and therefore to facilitate *"relevant, useful and comparable"* reporting (NFRD, 2014; Article 2, p. L 330/8). In 2019, an additional set of guidelines on the disclosure of climate-related information was published, as part of the Sustainable Finance Action Plan (European Commission, 2020b).

[14] Users of non-financial information are defined by the Public Consultation study as the financial sector and social and environmental organizations.

[15] According to this principle, a company, if non-compliant, should explain why it not complying with the relevant recommendation of the applicable Corporate Governance code.

Corporate Governance code recommendation were classified as invalid, general, or limited, and therefore not informative.

3.2.1.2 Harmonization of disclosures

In Chapter 1 it is shown that ensuring comparable non-financial disclosures may require regulatory intervention because of the (positive) externality nature of harmonization efforts. In particular, the benefits of harmonization seem even more relevant taking into consideration the European context. Indeed, shares of multinational companies operating in the EU are often traded across different countries. Furthermore, without European legislation, these same undertakings may find themselves facing different disclosure obligations across the Member States, incurring pointless additional costs.

Unfortunately, the NFRD appears to have failed to achieve this objective. According to the EC's Public Consultation (2020), a percentage as high as 84% of users of non-financial information stated that the limited comparability achieved by the NFRD is a significant issue. It is possible to identify three main aspects that could be the cause of the Directive's nonperformance in terms of disclosure harmonization.

To start with, the NFRD is – as evidenced by the name itself – a Directive. In simpler terms, while trying to achieve harmonization in reporting practices in the EU, the European Commission opted for a legal instrument that gives discretion to the Member States in the form and methods used to achieve a defined binding result. For instance, according to the NRFD, the Member States have the power to require, when deemed appropriate, "*further improvements*" to the transparency of non-financial statements as provided by the Directive (NFRD, 2014, Recital 1, p. L 330/1). The choice of a Directive over a Regulation[16] has given way to differences in the transpositions by the Member States for a number of relevant issues, such as the methods and content of disclosure, the type of companies involved, and enforcement mechanisms. Therefore, reports produced by companies in the same industry may not be eventually comparable, as they will have to follow different disclosure requirements.

This result differences in transposition can be explained by the theory of "goodness of fit" between new European law and pre-existing national rules: Member States with low levels of fit between the newly introduced EU legislation and the national one are likely

[16] N.b. in the European law definition of the term)

to introduce the smallest change possible to national provisions, to try to maintain the *status quo* and minimize costs of adaptation (e.g., Heritier, 1994). However, Aureli, Magnaghi, and Salvatori (2019) proved that countries[17] may introduce substantial changes to their national law when transposing European legislation even if there is a low fit between the European and domestic provisions, leading to higher adaptation costs. Therefore, both effects considered, it is not clear whether convergence among the Member States can be achieved through a Directive on non-financial reporting.

A second element that contributed to hinder the harmonization of non-financial reporting – this time also at the national level – was the freedom of choice left to Member States and undertakings on the standards and frameworks to use for the sustainability reports. According to the NFRD, companies may rely on national, Union-based, or international frameworks, or even create their own unique framework. A staggering 81% of users of non-financial information reported that the duty to rely on a common standard would help to solve the problem of comparability between non-financial disclosure (European Commission, 2020b). In fact, while existing international frameworks are mostly aligned in terms of what they try to achieve, they all do it differently in practical terms. For example, the GRI developed specific standards and indicators for companies to use. For instance, according to Disclosure 302-1 ("Energy consumption within the organization"), a company has to report in terms of electricity, heating, cooling, and steam considering the distinction between renewable and non-renewable energy consumed and report it in joules following further specifications (Global Sustainability Standards Board, 2020, p. 6). Other frameworks such as the United Nations (UN) Global Compact give more of a principle-based guidance. The UN Global Compact provides 10 Principles (e.g., Environment - Principle 7: "Businesses should support a precautionary approach to environmental challenges") that companies should follow for implementing a sustainable approach to doing business (UN Global Compact, n.d.). For each Principle, companies are required to provide a description of implemented policies and measurement of outcomes, but no further directions or specifications are given.

Lastly, harmonization among reporting practices was likely hindered by the fact that more specific directions on how to report were provided in the EC's non-binding Guidelines (European Commission, 2017; 2019b). The Guidelines provide descriptions and

[17] They evidenced the peculiarity of the Italian case in this regard.

interesting insights on how to report information and would have helped to increase the comparability of information. For example, the definition of what is defined as material information – in other words, the information that should be reported according to the aim of the NFRD (the so-called "double materiality principle") – is outlined just in the Guidelines (2019). In the Directive (2014) itself the principle is somehow understandable by the context of Article 1(1), but not clearly defined. Furthermore, the Guidelines provide examples of KPIs that companies could use to evaluate the outcomes of their policies. KPIs are an excellent way of making information more comparable, both between companies and between past and present information of the same company). However, the non-binding nature of the Guidelines prevented their overall adoption and therefore the harmonization goal they were supposed to help to reach. As evidenced in a report by the Carbon Disclosure Project (CDP) (2018), within a sample of 80 companies subject to the NFRD requirements, only 25% reported on their business model following the five elements required by the Guidelines. Furthermore, the report also showed that the methodologies recommended for the calculation of relevant KPIs are rarely followed by companies, suggesting further studies into understanding the real usage of the Guidelines. All of this said, it is interesting to note that this result could have been expected: in Denmark – where similar rules on non-financial disclosure were introduced in 2009 – non-binding reporting guidelines suggested the usage of CSR indicators, but less than 40% of concerned companies eventually used any (Danish Commerce and Companies Agency, 2010; Szabó & Sørensen, 2015).

3.2.1.3 Reliability of disclosures

As discussed in Chapter 1, (financial or) non-financial information needs to be credible in order to truly avoid information asymmetry problems. Some authors pointed out that, given the discretionary nature of non-financial information, its assurance is even more crucial. However, the formal verification requirement[18] provided for by the NFRD offers even a lower level of assurance than that required by the Accounting Directive for financial information, where an external auditor has to certify whether financial records comply with the law and if they provide a "*true and fair view*" of the company financials (2013, Article 34, p. L 182/48),. For 73% of users of non-financial information surveyed in the Public Consultation (European Commission, 2020), the limited reliability of the

[18] i.e., auditors are required to verify just if the report has been produced or not.

reported information given by the Directive is an issue, and 78% of users agree with the imposition of stronger assurance requirements. As shown in the report written by de Groen et al. (2020), the share of European companies not assuring the content of their non-financial statements can be substantial in those countries where the Member State did not provide for an audit mandate of content (e.g., 90% of companies in Poland; 50% in Sweden[19]). While, clearly, in countries where there are nationally imposed verifications by independent assurance service providers – such as France, Italy, and Spain – basically all companies seek to assure their reports. This seems to go against the results of Ioannou and Serafeim (2017). It shows that the majority of companies do not have enough incentives to voluntarily seek assurance of the provided non-financial information. The NFRD with its non-prescriptive provisions for the Member States did not provide credible non-financial information to stakeholders, therefore did not help solve information asymmetry problems.

3.2.2 Secondary benefits: increased level of CSR activities

As reported in Chapter 1, regulation of non-financial disclosure can increase the level of CSR activities of a company. The extensive study conducted by de Groen et al. (2020) showed that two-thirds of surveyed companies reported changes in their internal practices and procedures (e.g., reduced energy consumption in the office; additional information requested from suppliers/clients) after being subjected to the NFRD requirements. Concerning policy changes, results are mixed, with 50% of companies reporting policy changes due to the NFRD and the other 50% reporting no change in policies. Thus, two issues could be pointed out. On one the one hand, it may be too soon to see policy changes because of the NFRD: indeed, the Directive has been in place for just three reporting periods and policy changes may require more time. On the other hand, even if changes were made, it is important to understand whether these changes were really caused by the mandatory reporting or rather by other institutional arrangements (e.g., other enacted policies) or stakeholder demand for them. Besides, non-financial disclosure regulation – as already explained in Chapter 1 – can complement more conventional regulatory choices to address negative externalities, but it should be its *secondary* aim. The EU has already a substantive number of policies in place to address environmental and social

[19] Excluding Austria, Belgium, Germany, Denmark, Spain, Finland, France, Italy, the Netherlands, Poland, Sweden, and the UK, the other EU countries showed an average of 67% of content not assured (de Groen et al., 2020).

issues. Just concerning environmental protection, the EU has in place policies in a vast number of areas, such as waste management, climate change mitigation, biodiversity protection, air, and water quality, and so forth. From the social point of view, many labor law provisions protect employees' welfare. Therefore, the question becomes whether regulation of non-financial disclosure is really needed if it is not able to address its primary aims and if the negative externalities it helps to solve could possibly be better addressed by other policy instruments.

3.2.3 The costs behind the NFRD

This research focuses more on the benefit side of the NFRD. However, it is worth mentioning a brief overview of the main costs behind the Directive. The NFRD entails all those regulatory costs described in Chapter 1: costs on the regulated entities, costs for the regulators, and other welfare losses (e.g., lobbying costs).

Costs of execution for firms (including data collection, drafting and publication of the report, potential assurance, and training costs) have been estimated to be between € 33,000 and € 604,000 per year per undertaking (European Commission, 2013). As also observed by Grewal et al. (2019), these costs do not seem substantial considering the scale of the firms concerned, i.e., large companies, as defined by the Directive. However, the Impact Assessment conducted by the EC prior to the NFRD failed to take into consideration the proprietary and political costs that may arise from the disclosure mandate, which may be significant.

Concerning the costs for regulators, the Impact Assessment seems to overlook them. The EC just briefly states that the Directive *"will not have meaningful budgetary consequences"* for the budget of the EU or for public authorities (European Commission, 2013, p. 42) or again, that the cost for the following monitoring activity *"would not be significant"* (*ibidem*, p. 43). This reflects the tendency to consider disclosure regulations as without or with negligible costs, as evidenced by Ben-Shahar and Schneider (2015). However, a consideration of the costs for regulators is necessary to fully understand the Directive's impact, especially considering that part of these costs may be duplicated with future revisions.

Furthermore, lobbying activities were undertaken by business associations and the Member States. These actions increased the loss of resources associated with the

Directive. The business association EUROCHAMBRES (Association of European Chambers of Commerce and Industry) strongly opposed the EC's proposal and lobbied to maintain the *status quo*, i.e., a regime of voluntary disclosure (Grewal et al., 2019). Opposition came also from those Member States that did not have a previous domestic non-financial reporting regulation in place (around 90% of EU Member States, among which Germany) (Kinderman, 2020). This lobbying and search-for-a-compromise effort may be the reason why the original text of the Directive eventually changed significantly.

3.3 The NFRD as a Justifiable Compromise?

In brief, the NFRD does not seem to have achieved its primary benefits and evidence about its secondary benefits is even scarcer. Nonetheless, as a result of the NFRD being a pioneer regulation in the field of non-financial reporting, some of the decisions taken by the EU legislator could be justified from a Law and Economics perspective.

The EC avoided a "one-size-fits-all" full-harmonization approach that could have been achieved through a Regulation[20]. Such a decision avoids the halt of innovation in reporting practices, which is very much needed especially now as the field is rather new. As stressed by Hayek (1978), and subsequently by van den Bergh (2016), competition among different legal rules enables the emergence of learning processes. The EU space can be seen as a legal "laboratory": Member States are left to engage with parallel experimentations of different provisions. Thanks to the different legal experiments, it is possible to better understand the effects of alternative legal solutions to the same problem. In the case of non-financial regulation, the freedom left to the Member States (e.g., about increasing the scope of the Directive, about which reporting framework to use, or about the chance of mandating an audit content verification) enabled (or will enable) the EU to obtain evidence on which institutional arrangements and rules allowed for the best outcomes. This decision was also taken in the hope of bottom-up harmonization. In other words, the EU legislator probably hoped of a spontaneous harmonization of laws fostered by mutual learning among the Member States, without the imposition of a top-down full harmonization approach, especially for what concerns the reporting framework.

Moreover, a minimum harmonization approach was definitely the cheaper solution if compared to full harmonization. The flexibility left by the NFRD not only to the Member

[20] N.b. in the European law definition of the term.

States but to the undertaking themselves allows the EU legislator to exploit the information advantage of the regulated entities, avoiding expensive information costs at the regulator's level and excessive administrative costs for companies. Each company presumably knows better about which specific non-financial issues and related policies are critical for its activities, and the best way to report them. Therefore, it is in the best position to find the best solution. The given flexibility, therefore, avoids companies engaging in a hollow "box-ticking" exercise while reporting. Furthermore, the NFRD flexibility allowed for smaller adaptation costs for countries and undertakings. On the one hand, countries (companies) without a previous non-financial reporting legislation (system) did not have to face excessive costs of implementation. On the other hand, countries (companies) that already had such legislation (system) in place could improve on it without wiping everything out.

All of this being said, it seems that the needed benefits to justify a non-financial disclosure regulation were however not reached through this flexible, non-prescriptive approach. On the one hand, it may be a matter of time. Regulations often need to reach a maturity stage in order to drive change (e.g., Korca & Costa, 2020). On the other hand, those benefits may *never* be reached. If the first option is ruled out, in the end, the question is whether a stronger regulatory intervention would reach those benefits (without causing costs higher than those benefits it tries to reach), or whether not regulating in the first place is the most efficient solution. As pointed out also by Ben-Shahar and Schneider (2015, p. 253), lawmakers commonly believe that mandated disclosure is "*rich in benefits and low in cost*" and hence CBAs of mandated disclosure are often neglected or underestimated.

The EU has now proposed a revision of the NFRD, with what appears to be a stronger level of intervention and lower flexibility. However, at the same time, in its 2020 annual report, the Regulatory Scrutiny Board (RSB) highlighted the continuous decrease in quality of the Impact Assessments presented by the EC (Regulatory Scrutiny Board, 2020). In particular, the description of problems (and the available alternatives) appears to often be pre-determined and not impartial but rather influenced by the course of action favored by the EC. In the next Chapter, some of the changes coming with the new Directive will be analyzed, trying to shed some light on potential future implications and opening the way for empirical studies.

4 Forward-looking Analysis – The EU new 2021 Proposal: The Corporate Sustainability Reporting Directive (CSRD)

This Chapter first presents the revision of the NFRD as proposed by the EC in April 2021, the Corporate Sustainability Reporting Directive, and summarizes its main points. Finally, it contains a brief analysis of the proposed changes, considering their potential positive and negative consequences.

4.1 The Corporate Sustainability Reporting Directive (CSRD)

4.1.1 Overview

In April 2021, the EC published a proposal for a new Directive, the Corporate Sustainability Reporting Directive (hereafter, CSRD). The CSRD amends existing EU laws[21] and is intended to revise and strengthen the provisions of the NFRD. It is part of a package of measures aimed at strengthening the foundations for sustainable finance, namely the Taxonomy Regulation (2020/852) and the Sustainable Finance Disclosure Regulation (2019/2088), as part of the European Green Deal (2019). Concerning the timing, the EC plans to adopt the CSRD at the end of 2022, which means that companies will likely have to report based on the CSRD in 2024, based on the information from 2023. The revision was decided after preparers and users of non-financial disclosure reported numerous issues arising from the NFRD (European Commission, 2020b), and a prominent part of them has been analyzed in the previous Chapter.

4.1.2 Proposed changes and requirements

The EC proposed some major changes to the NFRD. Throughout the proposal, a shift from a principle-based approach to more stringent rules in reporting requirements is evident. The main changes are summarized here.

[21] Directive 2013/34/EU (the Accounting Directive), Directive 2004/109/EC (the Transparency Directive), Directive 2006/43/EC (the Audit Directive), and Regulation (EU) No 537/2014 (the Audit Regulation).

First, the scope of the Directive is now extended. All large companies[22] (listed or not) and all listed companies, except for listed micro-enterprises[23], will now be subject to the requirements of the CSRD (CSRD Proposal, 2021; Article 1(3)). This covers around 49,000 companies, representing 75% of the total EU turnover of limited liability companies and three times more companies than those obliged to report under the NFRD (European Commission, 2020b). In general, SMEs will be required to report according to a simplified regime and after an adjustment period (i.e., three years) to develop the necessary capacities.

Secondly, the EC proposed the development of mandatory EU sustainability reporting standards developed by the European Financial Reporting Advisory Group (EFRAG) (CSRD Proposal, 2021; Article 1(4)). The new standards will articulate how undertakings have to report on environmental, social, and governance issues. It will be based on current best practices in the field.

Thirdly, an EU-wide audit requirement is introduced (CSRD Proposal, 2021; Article 3(7-9)). Undertakings will now have to seek limited assurance for the non-financial information provided. In other words, auditors will have to check whether there is something that would suggest materially misstated information. A shift towards a stronger level of assurance is contemplated after three years of reporting under the CSRD.

Lastly, undertakings will have to report the non-financial information in the management report, without the possibility of publishing it separately (CSRD Proposal, 2021; Article 1(3)). Furthermore, undertakings will also have to digitally tag non-financial information (CSRD Proposal, 2021; Article 1(4)).

4.2 The Right Direction? Final Remarks

The EU decided to strengthen the *red tape* for what concerns non-financial disclosure regulation. Even though it is still a Directive, less discretion is left to the Member States in their transposition, and less discretion is also left to companies. It tackles the boilerplate language problem by relying more on specific rules rather than principles, and by removing the "comply-or-explain" rule. It answered the comparability problem by

[22] An undertaking is defined as "*large*" if it meets two of the following requirements: a balance sheet total of €20 million; a turnover of €40 million; 250 employees (Accounting Directive, 2013; Article 3(4)).
[23] A "*micro-enterprise*" is a company that has: a balance sheet equal to or lower than €2 million; a turnover equal to or lower than €2 million; and fewer than 10 employees (European Commission, 2020c).

mandating a specific framework for all companies. It tries to increase the reliability of information by mandating the assurance of non-financial reports.

The proposed changes *seem* to go in the right direction, as they tackle those provisions of the NFRD that impeded the achievement of the main benefits of non-financial regulation, such as informativeness, comparability, and reliability of the information. However, these changes still need careful consideration. First of all, they will generate more costs. As evidenced also in Chapter 2, firms are not already voluntarily complying with the proposed changes. Under the NFRD, just an extra 9,000 firms were reporting under the Directive without having a legal obligation to do so (de Groen et al., 2020). The enlarged scope of the CSRD (from 11,000 to almost 50,000 firms) will therefore more than double the affected firms, which will incur adaptation costs. Furthermore, the majority of EU firms have not been assuring their non-financial reports, unless it was mandated at the national level. Also considering the proposed EU reporting standards, virtually all firms will face adaptation costs as these standards will be created from scratch. Secondly, it will need to be checked whether the proposed benefits will be reached, and if they will be higher than the costs.

Furthermore, it is interesting to reflect on the EC's decision to develop *ad hoc* non-financial reporting standards. This decision probably stems from the need for alignment among different EU Directives and Regulations[24], and by the fear that an "external" standard could not take into account the specificity of the European context. Nevertheless, the development of these new standards will entail additional costs, while the proposal itself stated the importance of improving non-financial reporting *"at the least possible cost"* and of reducing *"unnecessary costs"* (CSRD Proposal, 2021, p. 3, 4). To start with, a change in the governance structure of the EFRAG may be needed, because at the moment it does not seem to possess the right competencies to perform non-financial standard-setting (e.g., Gauzès, 2021). Also, the EFRAG will need significant resources to develop the standards themselves. It should be further investigated whether the adoption of an internationally recognized framework that is sufficiently widespread and rule-based (e.g., such as the GRI framework) would have been a more efficient alternative. Nevertheless, more than half of the Public Consultation respondents (51%) stated that the GRI framework could address the NFRD issues on its own (European Commission,

[24] In particular, the Taxonomy Regulation (2020/852) and the Sustainable Finance Disclosure Regulation (2019/2088).

2020b). Furthermore, there seems to be a growing desire for an international convergence in the field of non-financial reporting (e.g., Impact Management Project, 2020). If the leadership role the EU wants to play (i.e., pushing the global agenda to adopt similar standards as the ones developed by the EFRAG) will not be followed by other stakeholders – such as the Securities and Exchange Commission (SEC) or the IFRS Foundation – this effort will result in a loss of resources for regulators and for regulated entities in the form of additional regional standards.

5 Conclusions

From a Law and Economics perspective, it is hard to define an *ex-ante* case in favor or against non-financial disclosure regulation. As analyzed in Chapter 1, regulation of non-financial disclosure could be justified by the existence of three kinds of market failure: information asymmetries, negative externalities, and positive externalities. First, non-financial disclosure can alleviate information asymmetries problems, namely adverse selection and moral hazard. However, if the benefits that come with disclosure – i.e., increased market liquidity, lower cost of capital, and better managerial decisions – are higher than the related costs, a firm will have an incentive to provide the information, without the need for regulation. Still, a regulation could help to increase the informativeness of disclosure by, for example, lowering the use of boilerplate language, and increasing the reliability of the information provided with an audit mandate. Second, a requirement to engage in non-financial disclosure can decrease the negative externalities generated by firms. Nevertheless, there are better policy instruments specifically tailored to tackle negative externalities and this cannot be the primary justification of disclosure regulation. Third, regulation of non-financial disclosure could be justified by the positive externalities generated by reporting firms, e.g., harmonization of disclosures. However, this is not sufficient. It is essential not to neglect regulatory costs – for the regulator, the regulated entities, and society – not to fall prey to the *"Nirvana"* approach.

The pioneer NFRD that entered into force in the EU in 2014 seems to have failed to reach the potential benefits of a non-financial reporting regulation, in particular in terms of informativeness of disclosure, comparability, and reliability of the information. The vague and open formulations of the NFRD undermined informativeness. Harmonization of reporting practices was hindered by the legal instrument itself, excessive discretion in terms of transposition by the Member States and implementation by firms, and non-binding instructions. Reliability of information was also not achieved, as firms sought assurance just in those Member States where it was mandated by national transposition. This flexible, non-prescriptive approach adopted by the EU legislator on the one hand did not impede innovation processes in reporting practices and allowed for lower costs. On the other hand, it did not achieve the suggested benefits. If this result is not a matter of regulation maturity, the EC should ask itself whether a stronger, more pervasive regulatory intervention would reach those benefits – without causing higher costs – or whether not regulating in the first place (i.e., the market failure itself) is the most efficient solution.

The CSRD Proposal presented in April 2021 illustrates that the EC has decided to go down a more prescriptive and rigid line. More firms will be affected, a specific reporting framework will be mandated, and limited assurance will be required. Even though theoretically it seems like the proposed changes could address the shortcomings of the NFRD, more theoretical and empirical research is needed. Indeed, the proposed modifications will likely entail higher costs with respect to the NFRD, and some of them may not be entirely justified, such as the development of EU sustainability reporting standards.

At the moment, the CSRD Proposal is being negotiated by the European Parliament and the Council, and as it already happened with the NFRD, there is the possibility that the original text will undergo significant amendments. For this reason, future studies should investigate potential alternatives to support the current policy-making process. Future research should focus on understanding whether with the CSRD the benefits of non-financial regulation will be met and investigate the scale and reasonableness of its costs. In particular, it would be useful to develop more research on the scenario without governmental intervention. Further studies could also investigate the potential impacts of the CSRD costs considering that regulated entities will have to comply right after the economic crisis caused by the Covid-19 pandemic crisis.

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