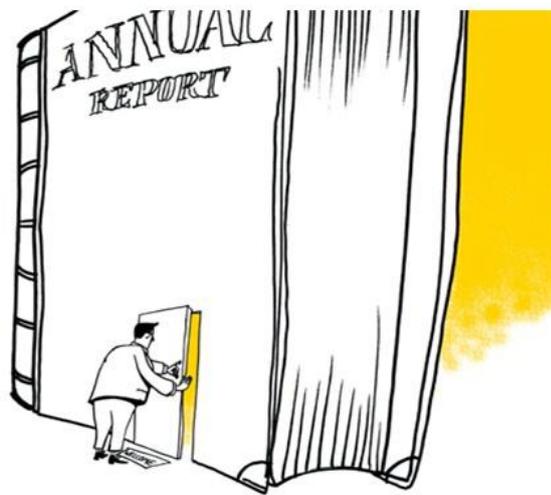


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# EU REPORTING REQUIREMENTS: LEADING THE WAY TO RESPONSIBLE CORPORATE CONDUCT?

Master Thesis by: Thirza Moolenaar

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## INTRODUCTION

In 2014, the European Union (EU) adopted the Non-Financial Reporting Directive (hereafter ‘the Directive’).<sup>1</sup> The Directive establishes an obligation for large undertakings<sup>2</sup> which are public-interest entities with over 500 employees to include in their management report a non-financial statement. This statement shall describe the undertaking’s ‘development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.’<sup>3</sup> In the impact assessment that accompanied the proposal for the Directive, the European Commission explained that, in order to fulfil their ‘social responsibility’<sup>4</sup>, companies should have in place a process to integrate non-financial and financial considerations into their business operations and core strategy, in collaboration with their stakeholders.<sup>5</sup> Such an integration process<sup>6</sup> leads companies to, inter alia, ‘identify, prevent and mitigate possible adverse impacts which companies may have on society.’<sup>7</sup>

In short, it can be said that the EU, with the adopted reporting approach, seeks to induce change in the reporting companies, towards better prevention of negative human rights impacts.<sup>8</sup>

The prevention of negative human rights impacts by corporations can be referred to as the business responsibility to respect human rights.<sup>9</sup> This responsibility was laid down in the United Nations Guiding Principles on Business and Human Rights (UNGPs), which by means of a three-pillar structure set out the responsibilities regarding human rights of States and companies respectively.<sup>10</sup>

<sup>1</sup> Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups (hereafter ‘Directive’).

<sup>2</sup> This thesis will use ‘undertaking’, ‘entity’ and ‘company’ interchangeably.

<sup>3</sup> Directive, *supra* note 1, art 1, inserting art. 19(a) and art. 29a.

<sup>4</sup> The European Commission (EC) uses ‘social responsibility’ to highlight the voluntary nature of responsibilities that fall under the umbrella term of corporate social responsibility (CSR). The European Union (EU) definition of CSR is: ‘the responsibility of enterprises for their impacts on society’. See Commission staff working document impact assessment. Accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups SWD/2013/0127 final (hereafter ‘Impact assessment’) and Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. A renewed EU strategy for Corporate Social Responsibility COM/2011/0681 final (hereinafter CSR Communication).

<sup>5</sup> Impact assessment, *supra* note 4, p. 37.

<sup>6</sup> ‘In order to fully meet their social responsibility, enterprises should therefore have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in collaboration with their stakeholders.’ In Impact assessment, *supra* note 4, p. 4.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*, p. 38: ‘This may have positive effects on overall management, through a better consideration of non-financial parameters in designing business strategies.’ The adoption of the Directive follows CSR Communication, *supra* note 4. In this document, a reporting law was announced.

<sup>9</sup> ‘Human rights’ will refer to the rights contained in the International Bill of Human Rights, which consists of the Universal Declaration of Human Rights, the International Covenant on Economic, Social and Cultural Rights, and the International Covenant on Civil and Political Rights and its two Optional Protocols.

<sup>10</sup> This writer uses the United Nations Guiding Principles on Business and Human Rights (UNGPs) as a benchmark to derive the meaning of responsible business conduct. See Office of the High Commissioner on Human Rights, Guiding Principles on Business and Human Rights: Implementing the United Nations “Protect, Respect and Remedy” Framework, [2011] UN Doc. HR/PUB/11/04, available at [http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR\\_EN.pdf](http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf). Since 2011, with the endorsement by the United Nations (UN) Human Rights Council of the UNGPs, it is recognized that

However, Buhmann critically analysed the Directive and concluded that it misses the elements that are necessary to enable the necessary organizational change which is needed to prevent negative human rights impacts.<sup>11</sup> From Buhmann, and others, it can be deduced that to serve as a catalyst for the desired change, a regulation is needed that approaches reporting as a process that stimulates organizational learning.<sup>12</sup>

The question rises what a reporting regulation should look like in order to stimulate organizational learning towards business respect for human rights. This question can be described as a socio-legal question.<sup>13</sup> The analysis which is needed to answer this question is two-fold: this can be accomplished by first exploring how theories of organizational learning explain the way companies change their decision-making following reporting. Such an exploration serves to better understand the social context in which the law operates, which is typical to socio-legal studies.<sup>14</sup>

Secondly, the role of law in stimulating the required organizational change will be explored. The EU emphasized that the development of corporate social responsibility (CSR) should be led by enterprises themselves.<sup>15</sup> This is reflected in the reasoning for the adoption of the Directive: by designing a reporting regulation which will enable companies to integrate human rights concerns into

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businesses have a responsibility to respect human rights. While the UNGPs do not create a legally enforceable duty to respect human rights, the Guiding Principles are (increasingly) said to give authoritative parameters of what constitutes desirable business behaviour. The European Commission referred to the UN Guiding Principles for 'authoritative guidance' in their renewed EU strategy for CSR. See *supra* note 4. Indeed the critiques and analysis of the Directive are construed against the benchmark of the United Nations Guiding Principles on Business and Human Rights. See K. Buhmann, 'Neglecting the Proactive Aspect of Human Rights Due Diligence? A Critical Appraisal of the EU's Non-Financial Reporting Directive as a Pillar One Avenue for Promoting Pillar Two Action', *0 Business and Human Rights Journal* 0, 2017, pp. 1-23, p. 1. See also for example K.H.M. De Roo, 'The Role of the EU Directive on Non-financial Disclosure in Human Rights Reporting', *12 European Company Law* 6, 2015, pp. 278-285.

<sup>11</sup> Buhmann 2017, *supra* note 10, p. 1.

<sup>12</sup> Adams and McNicholas refer to Kurt Lewin (1890-1947) as the 'as the intellectual father of contemporary theories of change'. They explain that he developed a 'holistic framework for considering the potential for sustainability reporting and the sustainability reporting process, to facilitate change towards greater accountability for improved sustainability performance.' In C. A. Adams and P. McNicholas, 'Making a difference: Sustainability reporting, accountability and organisational change', *20 Accounting, Auditing & Accountability Journal* 3, 2007, pp. 382-402, p. 385.

<sup>13</sup> Indeed, an examination of what the law could or should look like to meet the needs of particular groups of people is common to socio-legal studies. Socio-legal studies here broadly means the study of the interaction of law in the social context in which it operates: 'an interface with a context within which the law exists'. Quote from S. Wheeler and P. A. Thomas, 'Socio-Legal Studies' in D. J. Hayton, (ed), *Law's Future(s)* (Oxford, Hart Publishing, 2002) 271. Accessed via R. Banakar and M. Travers, 'Introduction' in R. Banakar and M. Travers (eds), *Theory and Method in Socio-Legal Research* (Hart Publishing 2005) p. xii. Donald Harris, former director of the Socio-Legal Centre at Oxford University wrote: 'There is no agreed definition of socio-legal studies: some use the term broadly to cover the study of law in its social context, but I prefer to use it to refer to the study of the law and legal institutions from the perspectives of the social sciences.' Accessed via P. Thomas, 'Socio-Legal Studies: The Case of Disappearing Fleas and Bustards', in P. A. Thomas, *Socio-Legal Studies* (Dartmouth Publishing Company Limited, 1997), p. 2. Thomas furthermore notes that The ESRC Review stated: "'Socio-legal studies' is an umbrella for what is now an exciting, wide ranging and varied area of research activity. In all its forms, the approaches of socio-legal scholars to the contextual study of law processes are very different from the pure doctrinal research which has been the staple of traditional legal scholarship. However, the diversity of activity that is subsumed under the label socio-legal studies makes the simple definition difficult to achieve [...]' Accessed via Thomas 1997 (see above) p. 2.

<sup>14</sup> *Supra* note 13.

<sup>15</sup> See under Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups COM/2013/0207 final (hereafter Explanatory Memorandum), 'Context of the Proposal'. See also 'CSR should be company led. Public authorities can play a supporting role through a smart mix of voluntary policy measures and, where necessary, complementary regulation.' On [https://ec.europa.eu/growth/industry/corporate-social-responsibility\\_en](https://ec.europa.eu/growth/industry/corporate-social-responsibility_en). Last accessed 24-9-2018.

their core strategies, the legislator brings together stakeholders and companies to exchange ideas on what ideal decision-making should look like. Such a use of law, where it does not aim to prescribe a particular substantive outcome, but aims ‘to encourage self-reflective processes within corporations regarding the impact of their actions on society’<sup>16</sup>, is an example of the functioning of law as explained in reflexive law theory.<sup>17</sup> A regulation that prescribes social reporting, as this Directive does, is indeed deemed a realisation of reflexive law.<sup>18</sup> Therefore, it is necessary to further review reflexive law theory, to understand what it aims to accomplish and to understand how the reporting framework could be adapted to effectively fulfil an encouraging role towards organizational change.<sup>19</sup> On the basis of such examination, recommendations will be provided regarding the design of a reporting regulation to enable responsible business conduct.

Based on the above, this thesis will thus investigate the following question: **How could the EU achieve its objective of stimulating responsible business conduct by changing the Non-Financial Reporting Directive to align with how theories of organizational learning and literature on reflexive law explain that companies change their decision-making following reporting?**<sup>20</sup>

The relevance of the question builds on the premise that legislation should be effective, meaning that it achieves what it sets out to accomplish: a characteristic that is deemed part of the elements that constitute the legitimacy of legislation.<sup>21</sup> The answering of the question will serve to assist the exploration of regulatory options to enhance responsible business conduct as it addresses the question of what the law should look like.<sup>22</sup> The question of effectiveness is all the more important considering

<sup>16</sup> D. Hess, ‘Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness’, 25 *The Journal of Corporate Law* 1, 1999, pp. 41- 84, p. 51. See also B. Choudhury, ‘Social Disclosure’, 13 *Berkeley Business Law Journal* 1, 2016, pp. 183-216, p. 206: ‘Metaregulatory approaches can prompt corporations to internalize social values which can then instigate changes to their behaviour.’

<sup>17</sup> G. Teubner, ‘Substantive and Reflexive Elements in Modern Law’, 17 *Law & Society Review* 2, 1983, pp. 239-286, p. 255.

<sup>18</sup> Choudhury 2016, *supra* note 16, p. 206. Also: C. Z. Wagner, ‘Evolving Norms of Corporate Social Responsibility: Lessons Learned from the European Union Directive on Non-Financial Reporting’, 19 *Transactions: The Tennessee Journal of Business Law*, 2018, pp. 619 -708, p. 697.

<sup>19</sup> This research is not a comparative study of the reporting requirements and other (voluntary) reporting frameworks that are used by business to report.

<sup>20</sup> The question will address the design of reporting approach and not include compliance with the reporting obligations themselves in terms of quantity and quality of statements. Questions of accuracy and verification thereof through auditing have been left outside of the scope of the analysis too.

<sup>21</sup> Monkelbaan states: ‘Legitimacy, broadly understood, can rest on a range of qualities and characteristics including law, but also authenticity, responsiveness, and problem-solving capacities.’ See J. Monkelbaan, *Experimentalist Sustainability Governance: Jazzing up Environmental Blues?* Center for International Sustainable Development Law, Public Participation and Climate Governance Working Paper Series, 2015, p. 3. See also ‘First, rights and obligations must be legitimate. This is an objective element. It is a question of fact. Second, rights and obligations must be effective. Rights and obligations must come into effect at least at some point in time.’ In T. Thorp, ‘The Right to Know and the Duty to Disclose: Pathways to Effective Monitoring, Reporting, and Verification within the Constitutionalism of Climate Justice’, 30 *Pace Environmental Law Review* 1, 2012, pp. 140-254, p. 141.

<sup>22</sup> This research builds on the tradition that studies law as an instrument for social change: ‘Social change is held to occur only when social structure – patterns of social relations, established social norms and social roles – changes.’ In R. Cotterrell, *The Sociology of Law. An Introduction* (Butterworth & Co, London, Dublin, Edinburgh, 1992), p. 47. The starting point of the research is that the desired social change is improved corporate respect for human rights. This at the same time is an interest of the researcher: it is hoped that companies also aim to improve their respect for human rights. See for a discussion

that adopting reporting requirements is the most used regulatory tool by governments to steer corporate conduct, as will be explained in chapter 1.

In the preparation phase of the Directive, it was acknowledged that the integration of human rights concerns into a company's core strategy should happen in collaboration with the company's stakeholders.<sup>23</sup> In fulfilling their responsibility to respect human rights, the UNGPs explain that businesses should engage with those stakeholders whose rights can be directly impacted by the companies' operations: the 'affected stakeholders' or, the 'rightsholders'.<sup>24</sup> Therefore, this thesis will highlight how the Directive enables engagement between companies and the rightsholders.<sup>25</sup>

This thesis proceeds as follows. In chapter one, the context in which reporting emerged as a tool to enhance responsible business conduct shall be addressed. Furthermore, to start the exploration on how the EU can adapt its reporting approach, the current approach of the EU in stimulating responsible business conduct first needs to be understood. Therefore, this chapter introduces the objectives which inspired the adoption of Non-Financial Reporting Directive, and will set out the main reporting requirements that are relevant for this analysis.

To understand how a reporting regulation could stimulate organisational change, chapter two analyses what literature on organizational learning reveals about how companies change their behaviour. Gond and Herrbach have proposed a theory on organizational learning specifically in relation to reporting. Therefore, their work shall be central in the analysis.

Furthermore, to conduct the second part of the analysis on how the law can stimulate organizational change, literature on reflexive law shall be consulted to understand the impact of the law on the stimulation of learning.

In chapter 3, the analyses of the theories will be complemented by a review of available empirical studies on the impact of social reporting and social reporting laws on company performance in the field of business and human rights. Such a review serves to complement or nuance the organisational learning theory in chapter 2, and to add a further understanding to the social context in which the Directive, as reflexive law, functions.

Chapter four will include a discussion which builds upon the previous chapters. It will be analysed how the objectives and reporting requirements of the reporting directive as explained in

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on neutrality versus the declaring of commitments in schools of research: R. Lee, 'Socio-Legal Research – What's The Use?' in: Thomas 1997, *supra* note 13, pp. 82-83.

<sup>23</sup> *Supra* note 5.

<sup>24</sup> As their human rights can be directly impacted by a company's operations, rightsholders differ from other stakeholders such as investors, non-governmental organizations and consumers. See UNGPs, *supra* note 10, Guiding Principle 21. Harrison stipulates emphasizes that impact assessment processes should involve 'meaningful consultation with potentially affected groups and other relevant stakeholders', taking into account barriers to access of their engagement. Derived from J. Harrison, 'Establishing a meaningful human rights due diligence process for corporations: learning from experience of human rights impact assessment', 31 *Impact Assessment and Project Appraisal* 2, 2013, pp. 107-117, p. 113.

<sup>25</sup> See also Guiding Principle 18b: *In order to gauge human rights risks, business enterprises should identify and assess any actual or potential adverse human rights impacts with which they may be involved either through their own activities or as a result of their business relationships. This process should: Involve meaningful consultation with potentially affected groups and other relevant stakeholders, as appropriate to the size of the business enterprise and the nature and context of the operation.*

chapter one, correspond to the way in which companies are described to change their conduct in chapters two and three. On the basis thereof, suggestions will be made on how the EU can adapt its reporting approach to stimulate the improvement of responsible business conduct. These recommendations will align with how theories of organizational learning and literature on reflexive law explain that companies change their decision-making following reporting.

In the end, a conclusion will follow.

## CHAPTER 1: REPORTING LEGISLATION INTRODUCED

This chapter will introduce the reporting requirements that public-interest entities have to comply with according to the EU Non-Financial Reporting Directive. Furthermore, the objectives that inspire the adopted reporting requirements will be addressed. First, reporting as a tool to enhance business respect for human rights will shortly be introduced.

### 1.1 Reporting and the business responsibility to respect human rights

Traditional business scholarship assumed a separation of business and ethics.<sup>26</sup> However, the rise of globalisation led to a search of norms of desirable business behaviour, and the enforcement thereof. This search interrelates with many legal and political complexities.<sup>27</sup> However, while there still exist (geographical) differences of perception regarding the scope of a legal responsibility of business to respect human rights, a social responsibility in this regard is now widely acknowledged.<sup>28</sup> Such acknowledgement unfortunately does not mean there are no longer corporate human rights violations taking place. Notwithstanding that businesses already indicated to acknowledge the significance of business respect for human rights before the endorsement of the UNGPs, ‘both as a matter of legal compliance and as part of good practice’<sup>29</sup>, corporate violations of human rights are a continuing phenomenon at the time of writing.<sup>30</sup>

One of the complexities in the search for better corporate behaviour is the question what an enforceable obligation for companies to respect human rights should entail specifically.<sup>31</sup> While a conclusive global answer to this question is to be awaited for, corporate reporting of human rights

<sup>26</sup> See R. E. Freeman, ‘The politics of stakeholder theory: some future directions’, 4 *Business Ethics Quarterly* 4, 1994, pp. 409-421.

<sup>27</sup> Examples include, but are not limited to: the fading distinction between public and private actors in providing certain services and the consequences for social responsibilities of these actors: ‘the distinction between ‘public’ and ‘private’[...] is a wholly artificial one [...]’ in: R. Lipschutz, ‘Can Climate Change Us?’ 48 *Development and Change* 3, 2017, pp. 623-635, p. 632. See also J. G. Ruggie, *Just Business. Multinational Corporations and Human Rights*, (W. W. Norton & Company, 2013), *Introduction*, p xxvii.; The changing nature of global governance: In today’s globalised world, there is ‘no longer a single sovereign authority’. In C. Harlow, ‘Deconstructing Government?’, 23 *Yearbook of European Law* 1, 2004, pp. 57- 89, p. 59. The appropriateness of an international treaty to lay down human rights obligations for companies. See: Elaboration of an international legally binding instrument on transnational corporations and other business enterprises with respect to human rights, U.N. Human Rights Council Resolution A/HRC/RES/26/9, adopted in July 2014.

<sup>28</sup> In 2009, McBarnet noted that ‘Corporate Social Responsibility (CSR) has now become a routine element in the business and regulatory debate.’ in D. McBarnet, ‘Corporate Social Responsibility beyond Law, through Law, for Law’, *Working Paper Series*, (University of Edinburgh 2009/03), p. 1. This thesis will not elaborate on the different arguments that have been presented to advocate either for or against a responsibility for business to respect human rights.

<sup>29</sup> M. K. Addo, ‘The Reality of the United Nations Guiding Principles on Business and Human Rights’, 14 *Human Rights Law Review* 1, 2014, pp. 133-147, p. 135. Addo referred to the Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporation and other business enterprises, Human Rights Policies and Management Practices: Results from questionnaire surveys of Governments and Fortune Global 500 firms, 28 February 2007, A/HRC/4/35/Add.3.

<sup>30</sup> For high-profile cases that inspired the drafting of the Guiding Principles, see Ruggie 2013, *supra* note 27, pp. 3-19. For up-to-date case profiles about corporate human rights abuses see the website: <https://www.business-humanrights.org/>.

<sup>31</sup> Which complicates the explorations into the potential scope of a future binding treaty on the topic. See also B. Fasterling, ‘Development of Norms Through Compliance Disclosure’, 106 *Journal of Business Ethics* 1, 2012, pp. 73-87, p. 83. And for example the distinction between the responsibilities of parent companies and subsidiaries respectively.

related information as a tool to explore answers came to the fore<sup>32</sup> and is now the most used regulatory strategy by governments to steer corporate conduct regarding human rights.<sup>33</sup>

It is not solely due to the complexities that are connected to the formulation of precise substantive obligations for companies that reporting is an appreciated regulatory tool. Establishing substantive obligations is expected to risk reducing these obligations to minimum norms of desired behaviour, whereas reporting on practices is hoped to lead to a continual improvement of behaviour, because it allows for comparison of best practices.<sup>34</sup>

Furthermore, in literature it has been considered that reporting legislation is appropriate to stimulate responsible business conduct because this regulatory approach caters to the context in which a company operates; while complying with reporting obligations, companies enjoy the discretion to delineate the norms of suitable business behaviour in a context which the company understands better than the regulator.<sup>35</sup>

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<sup>32</sup> The (voluntary) practice of corporate reporting on their 'social impacts' can be linked to an older practice of social auditing. This practice goes back to the 1940s. See J-P. Gond and O. Herrbach, 'Social Reporting as an Organisational Learning Tool? A Theoretical Framework', 65 *Journal of Business Ethics* 4, 2006, pp. 359-371, p. 363. This author does not purport to provide a complete explanation for the emerging of social disclosure. There exist different explanations, one of them being a business case for the inclusion of non-financial information, as it is argued that this inclusion in the long-run does impact financial performance. See for example Y. Li *et al.*, 'The impact of environmental, social and governance disclosure on firm value: The role of CEO power', 50 *The British Accounting Review* 1, 2018, pp. 60-75, p. 61. And A. B. Carroll and K. M. Shabana, 'The Business Case for Corporate Social Responsibility: A Review of Concepts, Research and Practice', 12 *International Journal of Management Reviews* 1, 2010, pp. 85-105. A strong push in the practice of social reporting came about with the voluntary standard-setting by the independent global organization Global Reporting Initiative (GRI), founded in 1997 as a response to shareholders' demands for more transparency on environmental performance of companies, and soon thereafter, social and governance issues. The coming-into being of the organisation has been directly linked to the development of corporate reporting of social and environmental issues together, alongside 'financial information'. See for GRI's history: <https://www.globalreporting.org/information/about-gri/gri-history/Pages/GRI's%20history.aspx> Last accessed 11-9-2018. See also R. Hahn and M. Kühnen, 'Determinants of Sustainability Reporting: A Review of Results, Trends, Theory, and Opportunities in an Expanding Field of Research', 59 *Journal of Cleaner Production*, 2013, pp. 5-21. For a comprehensive overview of the emergence of corporate reporting see: M. S. Fifka, 'Corporate Responsibility Reporting and its Determinants in Comparative Perspective – a Review of the Empirical Literature and a Meta-analysis', 22 *Business Strategy and the Environment* 1, 2013, pp. 1-35.

<sup>33</sup> Hess notes: 'In light of this "value pluralism," the legislatively required social report proposed here is a way in which the law can follow the reflexive law approach and meaningfully guide corporations to be responsive to the public's expectations of what it means to be socially responsible.' In Hess 1999, *supra* note 16, p. 46. In recent years, several countries have adopted legislation that requires companies to report on human rights related information. For example in France, Nouvelles Régulations Economiques, No. 2001-420, Art. 116. since 2002 requires listed companies to include in their annual reports information on social issues and community engagement. The Dutch Corporate Governance Code since 2009 stipulates that the management board is expected to formulate a CSR policy and to submit it to the supervisory board for approval. Another recent example of a reporting law to improve business respect for human rights is the UK Modern Slavery Act. Under section 54 of the Act, companies that fall under the Act's scope need to prepare a slavery and human trafficking statement for each financial year of the organisation. That section aims to improve transparency of the companies' supply chains.

<sup>34</sup> Substantive obligations establish minimum levels of behaviour: 'Thus, corporations are not being encouraged to develop new solutions to existing (or potential) problems, but only to meet a certain minimum level of behavior.' In Hess 1999, *supra* note 16, p. 59. See also L. C. Backer, 'From Moral Obligation to International Law: Disclosure Systems, Markets and the Regulation of Multinational Corporations', 39 *Georgetown Journal of International Law*, 2008, pp. 101-142, p. 126.

<sup>35</sup> Choudhury explains it as follows: 'The idea behind metaregulation is that corporations, which possess superior information as to which internal rules and procedures are needed to address issues, should be encouraged to reorient their internal workings to address problems identified by the regulators. In this way, corporations possess ample flexibility to solve the problems they create.' In Choudhury 2016, *supra* note 16, p. 206.

Finally, Choudhury explains that adopting mandatory reporting requirements is a suitable regulatory strategy in the context of social issues, where there is a lack of consensus regarding the role of governments to prescribe, or intervene in, company behaviour.<sup>36</sup>

With the adoption of the Directive, the EU responds to the UNGPs guidance for States to stimulate corporate communication of human rights impacts. The importance of reporting in the enhancement of responsible business conduct has been endorsed in both pillar 1 and pillar 2 of the UNGPs. Under pillar 2, companies need to have in place a human rights due diligence process to identify, prevent, mitigate and account for how they address their impacts on human rights.<sup>37</sup> Guiding Principle 21 explains how companies can account for these impacts, by communicating the identified impacts externally.<sup>38</sup> Verification of corporate performance should be made possible, through communication in some form.<sup>39</sup> External communication of impacts is thereby included as a formal step of the human rights due diligence process that a company needs to carry out to respect human rights.<sup>40</sup> Communication in accordance with the UNGPs thus serves to prevent negative impacts. In addition, communication provides a form of accountability towards different stakeholders of the company.<sup>41</sup>

Under pillar 1, the UNGPs prompt States to encourage businesses to communicate their human rights impacts as part of their responsibility to respect, protect and fulfil human rights. Guiding Principle 3(d) sets out that States should ‘encourage, and where appropriate require, business enterprises to communicate how they address their human rights impacts.’<sup>42</sup> The commentary under this principle elaborates as follows: ‘State encouragement of, or where appropriate requirements for, such communication are important in fostering respect for human rights by business enterprises.’<sup>43</sup>

<sup>36</sup> ‘commentators have argued that governmental regulation in corporate law is mainly acceptable as a supplemental or limited device.’ In Choudhury 2016, *supra* note 16, p. 205. Choudhury words it as follows: ‘Rather than prohibiting or controlling corporate conduct, social disclosure obligations allow a relatively light-handed approach to curbing corporate conduct in the context of social issues’. In Choudhury 2016, p. 205. See also Backer who states: ‘Without incorporating any particular set of “public” values, international law can make it easier for people to manage the “public” or “social” behavior of multinational corporations through a mandatory regime of global reporting.’ In Backer 2008, *supra* note 34, p. 101.

<sup>37</sup> Guiding Principles, *supra* note 10, Principles 15(b) and 17.

<sup>38</sup> Guiding Principle 21 reads: *In order to account for how they address their human rights impacts, business enterprises should be prepared to communicate this externally, particularly when concerns are raised by or on behalf of affected stakeholders. Business enterprises whose operations or operating contexts pose risks of severe human rights impacts should report formally on how they address them. In all instances, communications should: (a) Be of a form and frequency that reflect an enterprise’s human rights impacts and that are accessible to its intended audiences; (b) Provide information that is sufficient to evaluate the adequacy of an enterprise’s response to the particular human rights impact involved; (c) In turn not pose risks to affected stakeholders, personnel or to legitimate requirements of commercial confidentiality.*

<sup>39</sup> Commentary under Guiding Principle 21: ‘Communication can take a variety of forms, including in-person meetings, online dialogues, consultation with affected stakeholders, and formal public reports. Formal reporting is itself evolving, from traditional annual reports and corporate responsibility/sustainability reports, to include online updates and integrated financial and non-financial reports.’

<sup>40</sup> *Id.*, Guiding Principles 15(b), 17 and 21. Communication under pillar 2 can be distinguished from formal reporting as required by the Directive. In her assessment of the Directive and its interaction with the UNGPs, Buhmann notes the following: ‘for communication as part of HRDD and therefore non- financial reporting to serve the objective of prevention of harm, the process needs to be undertaken from a broader approach that emphasizes understanding stakeholder perceptions of impacts both before they occur, and after the firm has sought to address them.’ Buhmann 2017, *supra* note 10, p. 14.

<sup>41</sup> Guiding Principle 21 and commentary.

<sup>42</sup> Guiding Principle 3(d).

<sup>43</sup> Guiding Principle 3(d) and commentary.

By aiming to improve transparency of the undertaking's non-financial performances, the Non-Financial Reporting Directive is a response to the UNGPs' guidance for States to protect human rights by their regulatory and policy functions.<sup>44</sup>

In the following paragraph, the objectives and reporting approach of the Non-Financial Reporting will be explored.

## 1.2 The Non-Financial Reporting Directive introduced

As mentioned, to explore how the EU can stimulate responsible business conduct by changing the Non-Financial Reporting Directive, the EU's current approach first needs to be understood. To extract the objectives pursued by the EU, the explanatory memorandum of the Directive will be reviewed, as well as the impact assessment which supported the proposal. In the final part, the reporting requirements presented in the Directive will be introduced.

### 1.2.1 The objectives pursued by the legislators

It can be ascertained from the explanatory memorandum of the Directive that the main objective of the Directive is to stimulate enhanced transparency regarding non-financial performance of public-interest entities.<sup>45</sup> Enhanced transparency is expected to lead to the realization of three other ambitions: better management by companies of non-financial risks and opportunities and thereby the improvement of the 'non-financial performance' of those companies<sup>46</sup>; the enabling of 'civil society organisations and local communities to assess the impact and risks related to the operations of a company'<sup>47</sup>; and, the ability for investors 'to take better account of sustainability considerations and long term performance' of companies.<sup>48</sup> In sum, improved transparency of the regulated matters is thus expected to lead to 1) better non-financial performance by companies, and 2) better accountability of companies towards a company's stakeholders.

The explanatory memorandum refers to the impact assessment that has been carried out to explore these objectives and the accompanying regulatory possibilities to achieve those objectives. To

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<sup>44</sup> Although the Proposal of the Directive and the impact assessment do not formulate the legislative endeavour as such. In Directorate-General for External Policies, Policy Department. European Parliament (2017), Implementation of the UN Guiding Principles on Business and Human Rights. EP/EXPO/B/COMMITTEE/FWC/2013-08/Lot8/09 study it is stated that The European Commission (EC)'s Communication on Corporate Social Responsibility (CSR) (European Commission, 2011) in 2011 set out steps and regulatory efforts aimed at contributing to the UNGPs' implementation. Study online accessible via [http://www.europarl.europa.eu/RegData/etudes/STUD/2017/578031/EXPO\\_STU\(2017\)578031\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/STUD/2017/578031/EXPO_STU(2017)578031_EN.pdf). Furthermore, as the Directive was announced as a legislative measure in the CSR communication, it could be perceived as a step aiming to contributing to the UNGPs' implementation. Furthermore, Commission Staff Working Document on Implementing the UN Guiding Principles on Business and Human Rights - State of Play SWD(2015) 144 final, mentions the Directive as implementation of Guiding Principle 3(d).

<sup>45</sup> Increased diversity in the boards of companies, as addressed in the Non-Financial Reporting Directive, has been left out of the scope of this thesis.

<sup>46</sup> See Explanatory Memorandum, *supra* note 15, under 'Context of the Proposal'.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

better understand the reasoning that fed into the formulation of the objectives, the following paragraph will therefore review the impact assessment.

#### Better accountability through improved transparency

In the impact assessment, accountability is assessed as crucial in changing corporate behaviour. This can be ascertained from the following phrase: ‘One could assume that if their nonfinancial impacts are not known to stakeholders, companies will have little incentive to adjust their behaviour and to take due account of non-financial externalities into their decision-making.’<sup>49</sup> The meaning of accountability is not specified, but the impact assessment purports that the expected improvement of availability of information in terms of quantity and quality can be used by ‘civil society organisations and local communities to assess the impact and risks related to the operations of a company.’<sup>50</sup> It can be derived that without this type of accountability in the form of information sharing towards stakeholders, the collected non-financial information is not expected to be used in the companies’ decision-making.<sup>51</sup>

Finally, under the heading of accountability, it is stated that ‘More and better reporting could increase consumers’ trust and have a positive effect on the demand side, creating new entrepreneurial opportunities and better management of externalities. Reporting would also act as a catalyst for companies to increase or improve their CSR practice.’<sup>52</sup>

#### Better performance through increased transparency

The impact assessment states that the specific inclusion of material risks in the field of ‘human rights’ will likely reduce the involvement of the targeted entities in human rights violations.<sup>53</sup> This is because companies will enhance their awareness of these risks due to the disclosure requirements.<sup>54</sup>

Regarding the relationship between transparency and the improvement of non-financial performance, the assessment reasons that because the non-financial performance results will be integrated in an annual report, the management board will review these results too: ‘This may have positive effects on overall management, through a better consideration of non-financial parameters in designing business strategies.’<sup>55</sup> To support this prediction, the impact assessment refers to a study from 2007 that reviewed the sustainability reporting of 540 EU companies which ‘found that the process of drafting such a report was among the most important catalysts for organizational change,

<sup>49</sup> *Id.*, p. 12.

<sup>50</sup> *Supra* note 47.

<sup>51</sup> The impact assessment does not explain how the disclosure of non-financial information will be taken into account into the companies’ decision-making.

<sup>52</sup> Impact assessment, *supra* note 4, p. 38. The assessment does not however support this statement with reference to any study, nor does it specify what form the reporting should take to work as a catalyst to increase or improve CSR practice.

<sup>53</sup> The impact assessment does not clarify the definition of material risks in the field of human rights.

<sup>54</sup> ‘Furthermore, by specifically requiring companies to disclose material risks in the field of human rights, the proposal is likely to have a positive effect on human rights awareness within companies and contribute to the implementation of the corporate responsibility to respect human rights. It is therefore likely to reduce instances of EU company involvement in human rights infringements.’ in Impact assessment, *supra* note 4, p. 41

<sup>55</sup> Impact assessment, *supra* note 4, p. 38.

contributing to the accumulation of knowledge, questioning of processes, and the establishment of suitable structures and practices.’<sup>56</sup>

Related to the above, the assessment states that the proposed reporting requirement of a non-financial statement may lead companies to ‘set up [...] or optimise processes and systems related to the collection and analysis of information. This may increase management awareness of non-financial performance.’<sup>57</sup> Thus, the impact assessment links the collection of information to management awareness of this information. In turn, management awareness of non-financial performance is linked to better performance.<sup>58</sup>

### 1.2.2 The different regulatory options available to the legislators and the adopted reporting approach

The impact assessment that accompanied the proposal for the Directive explored the different regulatory options that were available to the legislators.<sup>59</sup> The three options that were explored are 1) the requirement of disclosure within the Annual report; 2) establishing mandatory detailed reporting requirements; 3) setting up a mandatory EU standard. The consultation results in the impact assessment showed that imposing mandatory detailed reporting requirements was the least favoured option by the future ‘preparers’ (companies) of the report.<sup>60</sup> In the context of detailed reporting, companies most preferred voluntary reporting, followed by a comply-or-explain format.<sup>61</sup> This is in complete contrast to the consulted ‘users’ (NGOs), who most preferred mandatory reporting, followed by a comply-or-explain format. The least favoured option by consulted NGOs was voluntary reporting.

In the final Directive, a mix of the first two options has been adopted: the Directive mandates the public-interest entities to issue a statement in the Annual report and gives them the voluntary option to issue a separate report in case they wish to report in a more detailed manner.<sup>62</sup>

<sup>56</sup> Footnote 127 in the Impact Assessment. Study not accessible. It appears however that this concerned an examination of ‘stand-alone’ sustainability reports, and not the drafting of a non-financial statement within an annual report, as chosen as the preferred policy option for the Non-Financial Reporting Directive. It cannot therefore be excluded that the impacts of the writing of the non-financial statement on the design of business strategies and organizational change might be different than the impacts that were found in the cited study of separate sustainability reports.

<sup>57</sup> Impact Assessment, *supra* note 4, p. 38.

<sup>58</sup> This is not stated explicitly, however, this reasoning was provided under subparagraph 6.1.2 ‘Better performance of companies (and better risk management) in the Impact assessment.

<sup>59</sup> Impact Assessment, *supra* note 4.

<sup>60</sup> *Id.*, p. 30. See table 3 ‘Assessment of the Policy Options by Stakeholders Group’. This was the least preferred option by the writers of the impact assessment as well, as can be observed via the following assertion: ‘However, the effectiveness of such [mandatory reference to high quality reporting principles], provision is sometimes questioned. First of all, requiring detailed disclosure might result in companies perceiving reporting just as an additional administrative burden to comply with. This attitude would result in a ‘tick the box’ exercise, which would fail to change companies’ strategic, long term approach to non-financial risk management.’ Impact assessment, *supra* note 4, p. 65. The assessment did not refer to any studies to support this statement. Furthermore, there is no stated reason as to why these consequences would not apply to the preferred option of a statement within an annual report.

<sup>61</sup> Other options that were explored were the ‘disclosure in annual report’ and the adoption of a mandatory EU standard. Following the latter option, rather than relying on existing frameworks, the EU would adopt a new set of reporting standards.

<sup>62</sup> ‘This provision builds on existing practices and provides a limited but useful incentive to improve the quality of those reports. Information would be disclosed in reference to high quality, generally accepted international frameworks, and verified for consistency due to the inclusion in the Annual Report.’ In Impact assessment, *supra* note 4, p. 30. When

The requirements of the non-financial statement are laid down in Article 19 which instructs companies to include in their management report:

*a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters, including:*

- (a) a brief description of the undertaking's business model;*
- (b) a description of the policies pursued by the undertaking in relation to those matters, including due diligence processes implemented;*
- (c) the outcome of those policies;*
- (d) the principal risks related to those matters linked to the undertaking'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 undertaking manages those risks;*
- (e) non-financial key performance indicators relevant to the particular business.<sup>63</sup>*

The Directive adopts a 'comply-or-explain' approach for companies. In the same Article, it reads: *Where the undertaking does not pursue policies in relation to one or more of those matters, the non-financial statement shall provide a clear and reasoned explanation for not doing so.*<sup>64</sup>

It can be observed that although the Proposal for the Directive stated that companies should have in place a process to integrate, inter alia, human rights concerns into their business operations and core strategies, in collaboration with their stakeholders, the Directive is not designed in a way that directly steers companies to actively collaborate with their stakeholders: the Directive lacks a requirement on stakeholder engagement.

The Directive instructs Member States to provide that companies may rely on national, Union-based or international frameworks to assist them with writing the non-financial statement. If they do so, undertakings shall specify which frameworks they have relied upon.<sup>65</sup> This discretion has not gone without criticism. However, it stretches too far to elaborate on the impacts of this discretion.<sup>66</sup>

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companies choose to public a separate report, this may release them from the obligation to include a non-financial statement set out in art. 19 of the Directive. See Directive, *supra* note 1, art. 19(a)(4).

<sup>63</sup> Directive, *supra* note 1, art. 19a. When the reporting public-interest entity is the parent undertaking of a large group exceeding on its balance sheet dates, on a consolidated basis, the criterion of the average number of 500 employees during the financial year, it shall include the non-financial information in the in the consolidated management report. See Directive, art. 29a.

<sup>64</sup> *Id.* The impact assessment explains the approach as beneficial as they expect it might encourage best practices: 'The requirement for companies to give a reasoned explanation in case they do not have a specific policy in place may also increase peer pressure and encourage best practices, while retaining flexibility'. Impact assessment, *supra* note 4, p. 37, under 6.1.1. 'Increased Transparency'.

<sup>65</sup> Directive, *supra* note 1, Art. 19(1).

<sup>66</sup> See for example Buhmann who notes that from the available frameworks, the Eco-Management and Audit Scheme (EMAS) and GRI are actual reporting or 'accountability, schemes: 'The UNGP, OECD's Guidelines, UN Global Compact,

Finally, it is noteworthy that compliance with the reporting requirements of the Directive is to be ensured by the Member States: these are to adopt ‘effective national procedures’ to enforce compliance with the obligations of the Directive.<sup>67</sup>

### 1.3 Sub conclusions

With the adoption of the Directive, the EU chose to use social reporting as its regulatory strategy to enhance business respect for human rights. The legislators reasoned that reporting of the required non-financial information leads to better performance and better accountability. These two objectives work hand in hand: while information collection for drafting a report increases management awareness of these issues, the sharing of this collected information externally is crucial to provide an incentive to companies to adjust their behaviour. Management awareness of human rights issues alone is thus not deemed sufficient, although this is not communicated explicitly in the reviewed documents. In drafting the non-financial statement, companies may rely on various existing reporting and operational frameworks that relate to the topics that are to be addressed in the statement. Furthermore, if companies do not pursue policies in the described matters, they shall provide a clear and reasoned explanation. Compliance with the reporting requirements is to be ensured by the Member States.

In the following, the normative framework that will be used as a benchmark to explore how the EU can review its reporting approach will be presented.

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ISO 26000 and ILO’s Tripartite Declaration are operational guidelines rather than reporting schemes.’ In Buhmann 2017, *supra* note 10, p. 7.

<sup>67</sup> Directive, *supra* note 1, Preamble, Recital 10. Buhmann notes: ‘The focus remains judicial or based on assumptions that ex-post economic accountability by investors, buyers or consumers will shape business action sufficiently for the desired change to materialize.’ In Buhmann 2017, *supra* note 10, p. 21.

## CHAPTER 2: THEORIES ON ORGANIZATIONAL LEARNING AND REPORTING AS REFLEXIVE LAW

As explained in the introduction, to advance responsible business conduct, a regulation is needed that approaches reporting as a process that stimulates organizational learning (OL). This chapter will firstly look into the meaning of OL, which can be defined as ‘a change in the organization’s knowledge that occurs as a function of experience.’<sup>68</sup> OL research studies many different organisational forms and definitions of learning, and the research is fed by different disciplines and methods.<sup>69</sup> While a comprehensive explanation OL is not feasible in the scope of this thesis, it is a useful field of study to consult, as it observes and theorizes different patterns of behaviour by organisations in specific contexts. This chapter will first explore how the theory of OL developed by Gond and Herrbach explains how companies change their decision-making.<sup>70</sup> This theory specifically addresses reporting as a tool for OL in relation to responsible business conduct. It is therefore expected that this theory provides relevant insights to better understand how a regulation could be drafted that approaches reporting as a process that stimulates OL towards responsible business conduct. This analysis does not explore the impact of reporting in a systematic way, referring to the developed stage models of OL.<sup>71</sup> Rather, the main learning points that have been put forward by Gond and Herrbach’s theory will be reviewed. Although these relate to several of the developed stage models of OL, this is not specified throughout the analysis.

In the second part of this chapter, reflexive law theory will be reviewed to understand how the legislator can use reporting to stimulate learning towards responsible business conduct.

### 2.1 Social reporting as an organisational learning tool

In their proposition on reporting as a tool to enhance OL towards responsible business conduct, Gond and Herrbach distinguish between a social adaptation process, triggered by reporting, and a social learning process. This distinction is relevant, as reporting can generate the start of either of these two processes. Gond and Herrbach do not dismiss one approach over the other per se<sup>72</sup>, but they highlight

<sup>68</sup> L. Argote, ‘Organizational learning research: Past, present and future’, 42 *Management Learning* 4, 2011, pp. 439–446, p. 440.

<sup>69</sup> *Id.*, p. 443.

<sup>70</sup> Gond and Herrbach 2006, *supra* note 32.

<sup>71</sup> ‘Storage in memory’, ‘Action’, ‘Sensemaking’, ‘Distribution’, ‘Knowledge acquisition’, ‘Willingness to learn/ Problem definition’. In A. B. Antal and A. Sobczak, ‘Culturally Embedded Organizational Learning for Global Responsibility’, 53 *Business & Society* 5, 2014, pp. 652–683. Unfortunately, the scope of this thesis does not allow for an in-depth discussion of all the mentioned elements. For a recent article which summarizes many important areas of research of organizational learning in relation to CSR, see Z. Fortis *et al.*, ‘Unknown Knowns and Known Unknowns: Framing the Role of Organizational Learning in Corporate Social Responsibility Development’, 20 *International Journal of Management Reviews* 2, 2018, pp. 277–300.

<sup>72</sup> Gond and Herrbach 2006, *supra* note 32, p. 361: ‘these two forms of organisational learning and change should not be perceived as incompatible; in fact, both can be useful and even necessary within an organisation. Therefore, the two

the different impacts that the two processes have on corporate behaviour, as the processes impact management responses to information flows differently. Therefore, the following two paragraphs will explore both learning approaches.

### 2.1.1 Social adaptation

Gond and Herrbach explain that social adaptation is the change that happens when organisations adapt to their environment. This ‘incremental adaptation’ happens in response to stakeholder demands that are considered to be relevant to the organisation.<sup>73</sup> Learning results from ‘trial-and-error interactions between the firm and its environment.’<sup>74</sup> Mismatches identified in corporate practices or negative social impacts relating to some stakeholder group lead to ‘the adaptation of one or more dimensions of the management processes.’<sup>75</sup> However, despite adaptations to management processes, the adaptation does not challenge corporate culture and its values; rather, it occurs within a ‘fixed framework of culture and value systems’. Importantly, the authors stress that this adaptation process does not lead to a change of perception regarding the company’s ‘social responsibility principles’.<sup>76</sup>

The consequences of the adaptation process are described as ‘short term development of a higher level of corporate social outcomes (‘window dressing’),<sup>77</sup> and the nature of the outcome is described as ‘superficial’ and ‘highly environment contingent’.<sup>78</sup> The role of the external environment is crucial within this model, as adaptation occurs as a direct response to external pressure.

The use of reporting systems within this model is linked to the diagnostic use of management control systems<sup>79</sup>, also referred to as the ‘general feedback model’ of control.<sup>80</sup> This use of reporting requires ‘scarce top management attention’: ‘managers are only informed when outcomes differ from expectations, or when results are not in accordance with plans.’<sup>81</sup> Top management attention seems to be required once a year, to ‘approve targets’. The general feedback model relies on the use of control staff and accountants, which act as ‘emissaries of top management’.<sup>82</sup> This type of reporting is thereby expected to lead to corporate social adaptation. A compliance logic is applied, ‘whereby its goal is to

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mechanisms should be viewed as complementary [...] and research studying both processes showed that the organisational learning challenge is actually to strike an ideal *balance* between them [...].’

<sup>73</sup> *Id.*, p. 362.

<sup>74</sup> *Id.*, p. 361

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*, p. 362.

<sup>77</sup> *Id.*, Table 1.

<sup>78</sup> *Id.*

<sup>79</sup> Diagnostic control systems require a ‘mere monitoring of outcomes and deviations from standards.’ See also in this regard the analysis by Vitolla *et al.*: ‘The social changes that result from this circle are an operational and managerial consequence, leaving unchanged the strategic design defined by top management.’ In F. Vitolla *et al.*, ‘The integration of CSR into strategic management: a dynamic approach based on social management philosophy’, 17 *Corporate Governance: The International Journal of Business in Society* 1, 2017, pp. 89-116, p. 104. And on page 107: ‘Whenever the performances are incoherent to the strategic aims, the execution changes occur with the purpose to fill the strategic gaps.’

<sup>80</sup> Gond and Herrbach 2006, *supra* note 32, p. 366.

<sup>81</sup> *Id.*, Table II.

<sup>82</sup> *Id.*, Table II.

make sure that the risks faced by the company in terms of stakeholder demands are covered.<sup>83</sup> Indeed, one speaks of ‘risks’ faced by the company: the vision of the social environment here is described as ‘threat’ and ‘constraint’.<sup>84</sup>

### 2.1.2 Social learning

The social learning approach implies ‘the creation of knowledge and eventually questioning the organisations’ main objectives and mission’.<sup>85</sup> In contrast to the adaption approach, the learning approach does impact the responsibility principles of an organisation. The outcomes of the learning model are expected to result into a ‘higher level of corporate social outcomes in the long run, because they are caused by changed internal capacities and skills.’<sup>86</sup>

Social learning interacts with the social adaptation approach, in that the learning element ‘results from a crisis of social adaptation methods’.<sup>87</sup> It is a consequence of ‘persistent problems in corporate social adaptation’.<sup>88</sup> The external environment might provide the first trigger for the use of adaptation methods, in order to appease external stakeholders. When the ‘problem’ persists, the organization is forced to adopt a change of focus, from a short-term focus to a more long-term vision.<sup>89</sup>

Furthermore, ‘deep changes in stakeholder management processes’ are predicted to occur within the corporate social learning approach.<sup>90</sup> In contrast to the social adaptation approach which is said to entail a vision of the social environment as being a ‘threat’, the social environment in the social learning approach is considered an ‘opportunity’.<sup>91</sup> This was recently reiterated in relation to partnerships between NGOs and firms: ‘for actual learning to occur, the two partners need to view the relationship as an opportunity, identify common goals and expectations, and build bridges for learning together.’<sup>92</sup>

Regarding reporting, social learning occurs when both ‘top’ and ‘middle’ management have a strong commitment to the social reporting policies: ‘The process demands frequent and regular

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<sup>83</sup> *Id.*, p. 367.

<sup>84</sup> *Id.*, p. 366, Table II.

<sup>85</sup> *Id.*, p. 361

<sup>86</sup> *Id.*, p. 363.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* However, the authors do not specify what exactly triggers the process of social adaptation to change into a social learning process.

<sup>90</sup> *Id.*, p. 362, Table I.

<sup>91</sup> In a more recent article, Antal and Sobczak elaborate on problem definition within organisational learning theories. They explain that whilst most models rely on the need for recognition by managers of a problem to start the learning process, events and communications that are viewed as ‘opportunities’ (such as business anniversaries in the example they provide) can also trigger organisational learning. The scope of this thesis however does not allow for a further exploration into problem definition and organisational learning. See Antal and Sobczak 2014, *supra* note 71, pp. 652–683.

<sup>92</sup> In Fortis *et al.* 2018, *supra* note 71, p. 292. Fortis *et al.*, referring to D. Jamali and T. Keshishian, ‘Uneasy alliances: lessons learned from partnerships between businesses and NGOs in the context of CSR’, 84 *Journal of Business Ethics*, 2009, pp. 277–295.

attention from operating managers at all levels of the organisation.<sup>93</sup> Furthermore, this reporting process cannot represent a tick box exercise, as becomes clear from the following characteristics which are present when the reporting system is used interactively: ‘Data are interpreted and discussed in face-to-face meetings of superiors, subordinates and peers’.<sup>94</sup> Furthermore, ‘The process relies on the continual challenge of underlying data, assumptions, and action plans’.<sup>95</sup>

To illustrate the use of such an interactive reporting system, Gond and Herrbach provide the example of Danone group’s “Danone Way” tool as described by Antal and Sobczak.<sup>96</sup> The tool used was an interactive intranet website that functioned as a ‘virtual learning space’ for all Danone subsidiaries. The site included instruments for ‘self-evaluations and internal benchmarking on five stakeholder management domains: employees, shareholders, customers, suppliers, and local communities.’<sup>97</sup> The company reported in their annual sustainability reports on the progress that was made through this platform and on the indicators that were used to track progress. Furthermore, subsidiaries were required to carry out evaluation processes every two years and report on it: ‘The whole company is therefore “driven” by this reporting procedure, which has learning consequences.’<sup>98</sup> Importantly, Gond and Herrbach highlight that the reporting process resulted in ‘lower performance in the area of non-discrimination.’<sup>99</sup> Thus, an impact on the advancement of responsible business conduct using such interactive reporting system was measured.

Social adaptation is recognized as useful when it serves as the start of a learning process.<sup>100</sup> However, Gond and Herrbach indicate that more is needed than a ‘mere diagnostic use of corporate social reporting’. They describe that such a use of reporting ‘cannot contribute to organisational development and maintains the firm in a logic of compliance.’<sup>101</sup> Herrbach and Gond therefore argue that ‘organisational reporting about social performance can be viewed as a learning tool when used interactively’.<sup>102</sup> However, they acknowledge that both a diagnostic and interactive use of social reporting will always be used in a company, depending on how different issues are given priority.<sup>103</sup>

<sup>93</sup> Gond and Herrbach 2006, *supra* note 32, p. 362, Table I.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> This author was not able to access this article, the example is derived from Gond and Herrbach’s description. Original source: A. B. Antal and A. Sobczak, ‘Beyond CSR: Organizational Learning for Global Responsibility’, 30 *Journal of General Management* 2, 2004, pp. 77-98.

<sup>97</sup> Gond and Herrbach 2006, *supra* note 32, p. 367.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> Gond and Herrbach present a study case provided by Zadek (2004) of Nike, where it was described how under reputational pressures, Nike started to work on its supply-chain problems. Whereas firstly the process was more adaptive in nature, in the long run, cultural and strategic implications for the company were identified, ‘involving in particular a transfer from a short-term orientation to a longer-term vision.’ In Gond and Herrbach 2006, *supra* note 32, p. 363. Referring to S. Zadek, ‘The Path to Corporate Responsibility’, 82 *Harvard Business Review* 12, pp. 125-132.

<sup>101</sup> Gond and Herrbach 2006, *supra* note 32, p. 367.

<sup>102</sup> *Id.*, p. 359.

<sup>103</sup> *Id.*, p. 368: ‘Some dimensions of CSR will be monitored interactively and others diagnostically.’

## 2.2 Mandatory reporting as reflexive law in practice

In addition to the theory discussed above on OL and reporting, it is necessary to look at how the law can steer a learning process towards business respect for human rights. This is where reflexive law theory comes to the fore. Reflexive law theory as a hypothesis<sup>104</sup> was first developed by Teubner (1983) who analyzed two German neo-evolutionary theories of law in society<sup>105</sup> and drew from the work of Nonet and Selznick in the United States who offered a theory of ‘responsive law’.<sup>106</sup>

In relation to the regulation of companies, the problem to which reflexive law may offer a solution connects to the fact that ‘Today, judicial control and state regulation of associational behavior seem to reach the limits of their control capacity.’<sup>107</sup> The limits of the control capacity in relation to companies and establishing human rights obligations have been touched upon in chapter 1 of this thesis. In response, Teubner developed his theory of reflexive law which would constitute a ‘socially adequate “learning law”’.<sup>108</sup>

Learning occurs through the ‘reflexion mechanisms’ that can be established through law. Indeed, a mandatory reporting law can strengthen the ‘reflexion mechanisms’ within companies, thereby making the ‘organizational conscience work if it effectively forces the organization to “internalize” outside conflicts in its own decision structure.’<sup>109</sup> This first characteristic of reflexive law will be elaborated further in the last part of this section.

Reflexive law theory communicates a vision of the function of law in a postmodern society where law ‘seeks to design self-regulating social systems through norms of organization and procedure [...] it attempts to guide human action by redefining and redistributing property rights’.<sup>110</sup> Importantly, ‘[...] “reflexive” structures [...] compensate for inequality of power and information [...]’.<sup>111</sup> This latter point is the second characteristic of reflexive law which is relevant for a review of the Directive.

Teubner provides a useful illustration of the functioning of reflexive law with the example of two parties who conclude a contract: reflexive law does not intervene in the terms of an agreement,

<sup>104</sup> He stipulated that the functioning of reflexive law ‘can be seen as an emerging but as yet unrealized possibility, and the process of transition to a truly “reflexive” law can be analysed.’ In G. Teubner, ‘Substantive and Reflexive Elements in Modern Law’, 17 *Law & Society Review* 2, 1983, pp. 239-286, p. 242. See also on page 276: ‘To be sure, the ‘result’ we have reached is merely hypothetical in nature.’

<sup>105</sup> He looked into the work of Habermas and Luhmann in Germany.

<sup>106</sup> Teubner’s goal herein was to ‘transcend controversies between functionalism and critical theory and transform seemingly irreconcilable standpoints into complementary perspectives.’ in Teubner 1983, *supra* note 17, p. 245. He identifies several ‘weaknesses’ in Nonet and Selznick’s work on responsive law and seeks to complement this theory by elaboration. See pages 255 and 270 and 272. Teubner on the basis thereof developed a ‘new perspective on the process of legal and social change that permits [...] to point to a new “evolutionary” stage of law [...]’ In Teubner 1983, p. 242.

<sup>107</sup> *Id.*, p. 278.

<sup>108</sup> *Id.*, p. 264. Teubner in his work built on the observations of Luhmann, who reasoned that what was missing in post-modern society was a ‘conceptual system oriented towards social policy which would permit one to compare the consequences of different solutions to problems, to accumulate critical experience, to compare experiences from different fields, in short: to learn.’

<sup>109</sup> *Id.*, p. 278.

<sup>110</sup> *Id.*, pp. 254-255.

<sup>111</sup> *Id.*, p. 277.

like substantive law would. Furthermore, unlike formal law, reflexive law does not guarantee that certain, general, 'objective' conditions are met, such as whether 'there was a meeting of the minds'.<sup>112</sup> Law in a reflexive role will consider the social positions of bargaining parties and intervene in their bargaining positions, if externalities so demand:

'[Reflexive law] seeks to structure bargaining relations so as to equalize bargaining power, and it attempts to subject contracting parties to mechanisms of "public responsibility" that are designed to ensure that bargaining processes will take account of various externalities. However, within the limits of the arena that has been so structured, the parties are free to strike whatever bargains they will.'<sup>113</sup>

As reflexive law, mandatory reporting allows for a redistribution of information that, prior to disclosure, only the reporting company had. The disclosure thereby serves to equalize the bargaining power of the parties addressed in the law: information that without the new reporting requirements would not be publicly available, is now disclosed and gives the stakeholders a new bargaining role.<sup>114</sup> Ideally, the information allows the stakeholders to better assess and respond to the progress of a company in relation to the reported topics.

Teubner however warns that 'social asymmetries of power and information can resist institutional attempts at equalization.'<sup>115</sup> In response to 'interaction deficiencies between contracting parties' the law can interfere by defining 'objective purposes and duties' which are to steer the 'social self-regulation'.<sup>116</sup> Teubner continues to use the example of contract law, where a standard of 'good faith' then should 'compensate for irreducible inequities' between bargaining parties.<sup>117</sup>

Where social asymmetries of power and information resist attempts at equalization, reflexive law theory thus calls for institutional corrections.<sup>118</sup> Chapter 4 will discuss what this could mean for a review of the Directive.

As mentioned, the use of reflexive law means that the law does not require a specific outcome of a decision-making process.<sup>119</sup> In this regard, Hess (2006), using social contract theory as a

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<sup>112</sup> *Id.*, p. 255.

<sup>113</sup> *Id.*, p. 256.

<sup>114</sup> *Id.*, p. 256.

<sup>115</sup> *Id.*, p. 277.

<sup>116</sup> *Id.*, p. 277- 278. Bernard *et al.* describe this purpose of the law as follows: 'A crucial aspect of reflexive law is that it involves [...] also an effort to use legal norms, procedures and sanctions to 'frame' or 'steer' the process of self-regulation; to that extent, the implementation of the frame is a matter of institutional construction, and is not left entirely to spontaneous forces.' C. Bernard *et al.*, 'Reflexive Law, Corporate Social Responsibility and the Evolution of Labour Standard: The Case of Working Time', ESRC Centre for Business Research, University of Cambridge Working Paper No. 294, p. 4. Last accessed 11-9-2018 via [https://www.cbr.cam.ac.uk/fileadmin/user\\_upload/centre-for-business-research/downloads/working-papers/wp294.pdf](https://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp294.pdf).

<sup>117</sup> *Id.*, p. 277.

<sup>118</sup> *Supra* note 116.

<sup>119</sup> Hess 1999, *supra* note 16, p. 63. See also Teubner 1983, *supra* note 17, p. 256: 'Reflexive law affects the quality of outcomes without determining the agreements that will be reached. Unlike formal law, it does not take prior distributions as given. Unlike substantive law, it does not hold that certain contractual outcomes are desirable.' Hess mentions the following benefits of reporting: social reports will achieve corporate social responsiveness by promoting: '(1) improved and informed corporate decisions with full understanding of the implications of any action; (2) accountability to the public through

normative standard, advocates that ‘what is needed is an agreement between the corporation and its stakeholders as to what responsible behavior is, followed by compliance with that agreement.’<sup>120</sup> In absence of a dominant norm which determines what constitutes responsible behaviour in a certain context, ‘the entire relevant community should be involved in determining what the appropriate norm should be.’<sup>121</sup>

When approaching the Directive as a mechanism which will steer the agreements between corporations and communities, it can be said that the public disclosure of information can subject the decision-making process of a company and its stakeholders, as contracting parties<sup>122</sup>, to mechanisms of ‘public responsibility’. Disclosure thereby will ensure that the stakeholders’ views are internalized in the company’s decision-making processes.<sup>123</sup>

This is a process which goes in two directions, as clearly explained by Hess: the internal aspect of the reflexive mechanism relates to the information collection for the report in collaboration with the company’s stakeholders. Following Hess’ proposition, stakeholder engagement is undertaken during the process of information collection for a report. Therefore, the understanding of the full impact of any action is predicted to include community perspectives on impacts.<sup>124</sup> It can thus be said that when reporting legislation adequately reflects the function of law as reflexive, the dialogue process between the company and the communities (or, rightsholders) is highly important. In this regard, an interwovenness of the role of law as reflexive with social learning theory can be ascertained: reflexive law can steer a dialogue process between a company and stakeholders. It gives the procedural umbrella by which external views can be internalized into a company’s decision-making process; this engagement is needed for a social learning process where changes in responsibility principles of a company occur, and thereby results in ‘higher level of corporate social outcomes in the long run’.<sup>125</sup>

The requirement of disclosure constitutes the external aspect of the reflexive mechanism. Disclosure through an annual report is needed to help track progress ‘towards meeting the demands society places on it’; to show ‘learning over time’.<sup>126</sup> Disclosure of the collected information

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disclosure; (3) an understanding of community and stakeholder expectations of business and of the evolution of those expectations; and (4) a measurement of progress towards meeting those expectations.’ In: Hess 1999, p. 82.

<sup>120</sup> *Id.*, p. 61. The parameters of what constitutes responsible decision-making depend on ‘continually evolving societal norms’. In Hess 1999, *supra* note 16, p. 63.

<sup>121</sup> *Id.*, p. 82.

<sup>122</sup> See Hess’ reliance on social contract theory: *Id.*, p. 61.

<sup>123</sup> *Supra* note 112.

<sup>124</sup> ‘These procedures should include the creation of dialogues with the corporation’s various stakeholder groups and the creation of dialogues within the corporation. It is imperative that the company develops a process that requires the creation of an actual dialogue between the corporation and its stakeholders and not simply a one-way survey.’ *Id.*, p. 68. Stakeholder engagement should inform the reporting process and a social report is ‘developed through the participation of stakeholders.’ *Id.*, p. 63.

<sup>125</sup> Herrbach and Gond 2006, *supra* note 69, p. 363. ‘We contend that stakeholder engagement, an important aspect of many organisations’ sustainability reporting process, has the potential to be a particularly powerful driver for change, because its purpose is to challenge the company’s role in social and environmental sustainability.’ In Adams and McNicholas 2007, *supra* note 11, p. 385.

<sup>126</sup> Hess 1999, *supra* note 15, p. 67, in footnote 182.

consequently provides ‘corporate accountability’: stakeholders can verify claims by companies on performance and are thereby enabled to respond to those.<sup>127</sup> Here it can be observed that Hess aligns the aspect of accountability through disclosure to Teubner’s proposition of reflexive law attempting to ‘subject contracting parties to mechanisms of "public responsibility"’.<sup>128</sup>

Finally, in relation to OL, Gond and Herrbach noted the following: ‘[...] a firm is likely to strike different balances with respect to its different stakeholders or to its appreciation of the relevant dimensions of social performance in its own context.’<sup>129</sup> To understand the consequences of reporting processes on the equalizing of bargaining positions<sup>130</sup> between the corporations and the affected communities, the question can be asked whether a legislator should demand a company to report specifically on which stakeholder groups have been engaged in what capacity.

### 2.3 Sub conclusions

This chapter researched the OL theory advanced by Gond and Herrbach. This theory explains the way companies change their decision-making through reporting. Importantly, these authors elaborate on the distinction between social adaptation and social learning. As social learning entails a deeper and more structural change in the responsibility principles that an organisation recognizes and applies to its decision-making, it is desirable that reporting requirements stimulate a social learning process. It was observed that to induce social learning, top management should apply interactive management control systems to those issues which will impact the learning process. From the Danone example, it can be deduced that a reporting process which enhances such learning, needs to be designed in such a way that drives the whole organisation. It was furthermore observed that although the external social environment can provide triggers to start a learning process, in order for the learning process to constitute social learning, the social environment should be perceived as ‘opportunity’, rather than ‘threat’ or ‘risk’. The outcomes in terms of adaptation of the reporting requirements of the Directive will be addressed in the discussion chapter.

Furthermore, this chapter looked at what it means for social reporting legislation to represent reflexive law. Following the work of Teubner, when designed as reflexive law, mandatory reporting redistributes information, which leads to the equalization of the bargaining positions of parties. This means that reporting obligations could serve to equalize the bargaining positions of the addressed stakeholders and companies. Where social asymmetries persist, reflexive law requires institutional correction. Furthermore, Hess highlighted that mandatory social reporting should effectively ensure

<sup>127</sup> *Id.*, p. 83.

<sup>128</sup> *Supra* note 113.

<sup>129</sup> Herrbach and Gond 2006, *supra* note 32, p. 368.

<sup>130</sup> Hess uses the term ‘mutual power increase’. He explicitly mentions: ‘The idea is not to focus on creating a "power-equilibrium," but to focus on growth and a "mutual power increase" where the corporation and its stakeholders can more effectively communicate and influence each other.’ However, it stretches too far for this thesis to elaborate on the difference between the two notions and the consequences.

that companies internalize outside conflicts into their own decision-making. Learning then happens over time, through the reflexive mechanisms that are established to ensure that these conflicts are internalized. It can be said that reflexive law provides the procedural umbrella for the engagement that is needed for a social learning process where changes in responsibility principles of a company occur, and thereby results in a 'higher level of corporate social outcomes in the long run'.

## CHAPTER 3: STUDIES ON THE IMPACT OF DISCLOSURE ON CORPORATE BEHAVIOUR

This chapter examines if and how social reporting has been identified to alter corporate decision-making towards better respect for human rights. Findings could complement, confirm or nuance the insights gained from the review of OL theory. This can occur when a study departs from the specific theory discussed in chapter 2, but where recent findings describe different (or similar) patterns of organizational behaviour as described in the theory. With regard to reflexive law theory, findings are expected to provide insight into the societal contexts in which reporting requirements, as reflexive law, respond. Within this chapter, the first paragraph will add a general note of methodological attention that should be considered in current and future analysis of measured impact of disclosure on corporate conduct, namely, the distinction between mandatory and voluntary disclosure requirements. The second part will analyse studies on the impact of social disclosure on corporate decision-making.

### 3.1 Mandatory versus voluntary disclosure

When researching measured impacts of disclosure requirements on corporate behaviour, it is important to distinguish measured impacts linked to voluntary reporting from those that result from mandatory reporting obligations.<sup>131</sup> Buhmann pointed out that in the Danish reporting context, enactment of mandatory reporting legislation impacted the potential of the reporting requirements on initiating a learning process: companies that voluntarily reported on CSR related issues, prior to reporting becoming mandated by law, did so with a ‘learning objective’, whereas companies that hadn’t reported on these issues before, now did with a ‘compliance’ objective.<sup>132</sup> This could be relevant for a revision of the Directive, as the consultation results in the impact assessment showed that imposing mandatory detailed reporting requirements were the least favoured by the future ‘preparers’ (companies) of the report.<sup>133</sup> Applying the findings of the Danish study to the analysis of the Directive suggests that the mandatory reporting requirements of the Directive will not stimulate a learning process for the companies that did not already report on the covered topics. However, a question remains whether reporting with a compliance objective hampers the advancement of responsible business conduct per se. In the context of the Danish study, it is not clear whether the different objectives reported by the companies were consequently linked to ‘better’ or ‘worse’ corporate conduct. Another challenge rises when assessing the usefulness of reporting schemes: it has been pointed out that firms that voluntarily

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<sup>131</sup> The ‘blurring’ of voluntary and mandatory disclosure has been indicated as a persistent methodological problem in disclosure research. See Editorial, ‘The effects of environmental, social and governance disclosures and performance on firm value: A review of the literature in accounting and finance’, *The British Accounting Review* 50 (2018), pp. 1-15, p. 4.

<sup>132</sup> Buhmann 2017, *supra* note 10, p. 15.

<sup>133</sup> *Supra* note 60.

report on social issues could do so for different reasons.<sup>134</sup> Therefore, in order to contribute to theory-building, an accurate assessment of the impact of voluntary reporting practices by the use of quantitative indicators should distinguish between the different reasons for companies to report.<sup>135</sup>

### 3.2 Described versus measured impact of reporting on corporate conduct

Different authors describe the many benefits that disclosure will have in terms of improved corporate behaviour. In 2016, Choudhury described that mandatory corporate disclosure of social impacts will steer companies to ‘reflect’ and ‘re-examine’ their own behaviour.<sup>136</sup> This effect has been predicted in relation to the Directive too.<sup>137</sup> Via the route of social disclosure, Choudhury considers that companies will be pushed to thinking into the ‘right direction’ and social values will be ‘internalized’.<sup>138</sup> In line with Hess’ writing, this internalization of social values is described to then impact decision-making.<sup>139</sup> Complying with requirements of social disclosure results in a practice of information gathering which allows managers to ‘ex ante identify problems’.<sup>140</sup> The element of information gathering for disclosure has also been emphasized by Kim Park, who describes how mandatory social disclosure can be linked to a more accurate accountability which is exercised on the stock market, as investors are now provided with information they would otherwise maybe not have access to.<sup>141</sup> Hess also links disclosure to accountability of the company towards different stakeholders, which impacts corporate decision-making.<sup>142</sup> Hess mentioned the role of stockholders, who can decide whether to invest in a company, and other stakeholders, who are enabled to ‘deciding whether or not to do business, or have any type of relationship, with the corporation.’<sup>143</sup> Therefore, Hess reasons, the pressure exercised by

<sup>134</sup> ‘the study of firms that voluntarily adopt particular reporting practices does not necessarily produce results that are generalisable to all companies. This is because the firms studied could have reason to adopt the practices other than for reasons of good citizenship and a belief in transparency.’ In C. Bernardi and A. W. Stark, ‘Environmental, social and governance disclosure, integrated reporting, and the accuracy of analyst forecasts’, 50 *The British Accounting Review*, 2018, pp. 16-31, p. 17.

<sup>135</sup> Also referred to as ‘the identification problem’: ‘These problems are examples of what is known in econometrics as the identification problem. How do we know that a statistical outcome consistent with theoretical predictions is indeed driven by the causal factor under investigation (i.e. the accounting regime) and not by another un-modelled causal factor (e.g. general changes in market liquidity caused by economic crisis)?’ In P. F. Pope and S. J. McLeay, ‘The European IFRS experiment: objectives, research challenges and some early evidence’, 41 *Accounting and Business Research* 3, 2011, pp. 233-266, p. 245.

<sup>136</sup> Choudhury 2016, *supra* note 16, p. 206.

<sup>137</sup> ‘The new duty of disclosing non-financial and diversity information has set a common standard for subjected companies and forces them to re-consider their practices that need to be reported.’ In: L. Matuszak and E. Róžańska, ‘CSR Disclosure in Polish Listed Companies in the Light of Directive 2014/95/EU Requirements: Empirical Evidence’, *Sustainability* 12, 2017, 2304, p. 3.

<sup>138</sup> Choudhury 2016, *supra* note 16, pp. 206- 207.

<sup>139</sup> *Id.*, p. 206.

<sup>140</sup> *Id.*, p. 196.

<sup>141</sup> ‘By expressly requiring that firms disclose specific kinds of social impacts, mandatory disclosure compels the production of information that firms may otherwise not voluntarily provide. Using this information, investors can more accurately account for such risks and the market can more efficiently discount the firm’s stock price accordingly.’ In S. Kim Park, ‘Targeted Social Transparency as Global Corporate Strategy’, 35 *Northwestern Journal of International Law & Business* 1, 2014, pp. 87- 137, p. 96. Neither Kim Park or Choudhury specify the form of reporting which they advocate.

<sup>142</sup> Hess 1999, *supra* note 16, p. 71.

<sup>143</sup> *Id.*

these stakeholders will push companies to align their decision-making with public expectations.<sup>144</sup> However, no studies were cited by Hess or Kim Park that indicate improved business respect for human rights following an increase in stock sales, or following divestment.<sup>145</sup>

Furthermore, while CSR disclosure has been linked to ‘greater consumer satisfaction’<sup>146</sup>, studies show that even when consumers indicate to denounce labor practices that violate human rights, product price and product desirability can outweigh ethical considerations in consumer choices.<sup>147</sup> It is therefore not clear whether managers will align their decision-making with public expectations through the route of consumer pressure, as consumers may continue to buy from companies that partake in problematic human rights performance.<sup>148</sup> Furthermore, while there is increased attention for business respect for human rights among shareholders<sup>149</sup>, the measured impact of shareholder proposals on decision-making is not straightforward.<sup>150</sup> However, a positive correlation in this regard

<sup>144</sup> *Id.* See also in a similar vein Kim Park: ‘Mandatory disclosure of adverse social impacts may have a socially beneficial effect on corporate conduct if corporate managers and boards seek to avoid moral disapprobation and act accordingly to avoid engaging in conduct that violates social norms.’ In Kim Park 2014, *supra* note 141, p. 96.

<sup>145</sup> Of course the exact terminology ‘respect for human rights’ by businesses originates from the UNGPs (2011) *supra* note 10. In coming to this statement, this author has looked for other terminology in the cited literature that would indicate a similar finding. It can be noted that a persistent incoherency of empirical research in the theory building of voluntary CSR reporting-reputation linkages has been observed by Pérez: ‘research that analyses the effect of information related to non-financial and non-regulated features, grouped as CSR reporting, is less numerous, more heterogeneous and less conclusive [...] Second, this stream of research is mostly theoretical in nature[...] and scholars have still developed very few empirical papers to discuss the validity of the theoretical approaches presented herein [...] the few scholars that have empirically examined how CSR information quality influences corporate reputation have only analysed the information quality in specific domains such as environmental management (Toms, 2002) or CSR reporting to customers (De los Ríos *et al.*, 2012). However, these papers do not provide a comprehensive understanding of the role that the information quality of all types of CSR reporting can have on corporate reputation. See A. Pérez, ‘Corporate reputation and CSR reporting to stakeholders: Gaps in the literature and future lines of research’, 20 *Corporate Communications: An International Journal* 1, 2015, pp. 11-29, p. 25.

<sup>146</sup> *Id.*, p. 20.

<sup>147</sup> On product desirability: N. Paharia *et al.*, ‘Sweatshop Labor Is Wrong Unless the Shoes Are Cute: Cognition Can Both Help and Hurt Moral Motivated Reasoning’, 121 *Organizational Behavior & Human Decision Processes* 1, 2013, pp. 81-88. See furthermore on the impact of higher prices on consumer choices, V. Gruber, ‘How Techniques of Neutralization Legitimize Norm- and Attitude-Inconsistent Consumer Behavior’, 121 *Journal of Business Ethics* 1, 2014, pp. 29 - 45. And T. Devinney *et al.*, ‘Values vs. Value: New Research Revealing a Disparity Between What Shoppers Say and What They Do Debunks the Myth of the Ethical Consumer’, *Strategy + Business* (Feb. 22, 2011) <https://www.strategy-business.com/article/11103?gko=03d29>: ‘The trouble with the data on ethical consumerism is that the majority of research relies on people reporting on their own purchasing habits or intentions, whether in surveys or through interviews. But there is little if any validation of what consumers report in these surveys, and individuals tend to dramatically overstate the importance of social and ethical responsibility when it comes to their purchasing habits.’

<sup>148</sup> Another limitation to a reliance on reputational risks comes from the concept of ‘bounded rationality’: ‘Bounded rationality is the idea that decisions are not only determined by the external environment, but also by the abilities and conflicting priorities of decision makers [...] Reputational risk exposure is a central driver in a company’s decision to implement SSCM practices. However, managers face bounded rationality, in particular: conflicting priorities; capabilities and resources; commitment; and contextual setting, which in turn, means that companies do what they can to safeguard their reputation, but balance the extent to which they implement SSCM and the cost of doing so against the likelihood of exposure.’ In K. Roehrich *et al.*, ‘Reputational risks and sustainable supply chain management: Decision making under bounded rationality’, 34 *International Journal of Operations & Production Management* 5, 2014, pp. 695-719, p. 695.

<sup>149</sup> For a useful overview of trends in this regard see G. Michelon and M. Rodrigue, ‘Demand for CSR: Insights from shareholder proposals’, 35 *Social and Environmental Accountability Journal* 3, 2015, pp. 157-175.

<sup>150</sup> One identified limitation in the measuring of the impact of shareholder engagement on respect for human rights is that it may be difficult to track impact when influence is exercised outside of the regulated systems such as during shareholder meetings: ‘Many shareholder activists have also achieved good results from bypassing this system and attempting to work directly with the company’s management team on CSR issues. Tracking the success of informal engagement processes by investors is made difficult by the ‘closed door’ nature of these discussions.’ In A. O’Rourke, ‘A new politics of engagement: shareholder activism for corporate social responsibility’, 12 *Business Strategy and the Environment* 4, 2003 pp. 227-239, p.

has been stressed by Eding and Scholtens who note that ‘Firms targeted by social shareholder proposals also have statistical significantly higher scores on employee wellbeing performance, human rights performance, and the overall social performance.’<sup>151</sup> The performance scores that these authors used in their research, are not publicly accessible. Therefore, there are limitations on completing further analysis of their findings. However, it can be said that the reviewed studies do not support a strong reliance by the legislators on the mentioned stakeholders to drive change in corporate decision-making. These findings furthermore provide insight into the bargaining position of the assessed stakeholders in relation to corporate decision-making. The findings can therefore serve a discussion of the Directive as reflexive law, which will follow in the next chapter. However, even when future empirical studies would indicate a strong correlation between stakeholder pressure and changed corporate decision-making, an assessment thereof should consider the distinction between a company’s response to external pressure which can be characterized as social adaptation, and decision-making which can be characterized as social learning. The former should, following the OL theory advanced by Herrbach and Gond, not be applauded directly by the legislators, as this type of response does not mean that responsibility principles that drive strategy have been changed.

There are research projects that analyse the impact of law on reporting practices<sup>152</sup>, studies that research the appreciation and use of different stakeholders of reports<sup>153</sup> and studies on the quality versus quantity of information in the reports<sup>154</sup>, also relating to the Directive.<sup>155</sup> Furthermore, there are studies that evaluate the ‘greenwashing’ function of disclosure<sup>156</sup>, and those that provide (positive) links between disclosure and firm value.<sup>157</sup> However, both Choudhury and Buhmann indicate that it is

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237. O’Rourke in addition questions the desirability of a reliance by the regulator on a certain group of shareholders to affect change in corporate decision-making.

<sup>151</sup> To come to their findings, these authors studied shareholder proposals on environmental, social, and governance issues at the annual general meeting of shareholders with US Fortune 250 firms during 2011–2014. They measure the CSR performance of a firm by several environmental, social, and governance performance scores that are provided by Thomson Reuters’ Asset4. This author unfortunately could not look into the performance scores provided by Thomson Reuters’ Asset4. See E. Eding and B. Scholtens, ‘Corporate Social Responsibility and Shareholder Proposals’, 24 *Corporate Social Responsibility and Environmental Management* 6, 2017, pp. 648-660.

<sup>152</sup> As referred to by Buhmann: Danwatch, *The Impact of the Danish Law on CSR Reporting*, report for the European Coalition for Corporate Justice (Copenhagen: Danwatch and ICCJ, 2011).

<sup>153</sup> H. Cho *et al.*, ‘CSR disclosure: the more things change...?’, 28 *Accounting, Auditing & Accountability Journal*, 1, 2015, pp. 14-35.

<sup>154</sup> C. A. Adams *et al.*, ‘Corporate Social reporting practices in western Europe: legitimating corporate behaviour?’ 30 *The British Accounting Review* 1, 1998, pp. 1-21.

<sup>155</sup> Matuszak and Różańska 2017, *supra* note 137, p. 3.

<sup>156</sup> See the references in Editorial, *The British Accounting Review* 50, 2018, *supra* note 131, p. 6. See also ‘Using this measure, poor environmental performers may actually have higher disclosure scores than good performers because they have greater exposures and must discuss any material financial information in their regulatory filings such as annual reports and 10 Ks.’ In P. M. Clarkson *et al.*, ‘Revisiting the relation between environmental performance and environmental disclosure: An empirical analysis’, 33 *Accounting, Organizations and Society*, 2008, pp. 303-327, p. 304. See furthermore S. Leung *et al.*, ‘Impression management through minimal narrative disclosure in annual reports’, 47 *The British Accounting Review*, 2015, pp. 275-289.

<sup>157</sup> Y. Qiu *et al.*, ‘Environmental and social disclosures: Link with corporate financial performance’, 48 *The British Accounting Review*, 2016, pp. 102-116; Li *et al.* 2018, *supra* note 32. See also K.T. Wang and D. Li, ‘Market Reactions to the First-Time Disclosure of Corporate Social Responsibility Reports: Evidence from China’, 138 *Journal of Business Ethics* 4, 2016, pp. 661- 682. These writers indicate that higher CSR reporting quality of Chinese companies has a positive impact on the market value of the company.

unclear whether social reporting actually changes corporate behaviour, due to a lack of (coherent) empirical research which demonstrates such correlation.<sup>158</sup> A problematic link was found between companies with ‘worse environmental performance’ who issued ‘more extensive environmental disclosures, presumably in an attempt to reduce the exposures arising from their environmental impacts.’<sup>159</sup> Such a finding is relevant in terms of understanding that elaborate reporting cannot simply be linked to good performance (in any case regarding environmental performance). Nor can it be assumed that when an elaborate report is issued which seems to have gone beyond a tick box exercise, that a (adaptive or social) learning objective was applied during the collection of information.

The next paragraph will summarize a case study which observed the learning process through reporting. The researchers specifically looked at whether the reporting processes stimulated social learning as described in OL.

### 3.2.1 Reporting as a process and organisational learning

Mitchell *et al.*, conducted a research project to understand the learning process of an irrigation company, Murrumbidgee Irrigation (MI), with regard to their sustainability related challenges, through reporting as a process.<sup>160</sup> The learning process they were trying to observe specifically was social learning as understood in OL theory (also referred to as ‘double loop learning’<sup>161</sup>). During a two-year timeframe, these researchers conducted several interviews with company staff to jointly plan and evaluate the reporting activities, which they referred to as Triple Bottom Line (TBL) reporting.<sup>162</sup>

The project confirmed a previously mentioned benefit of reporting: the reporting process starts a process of information collection which creates awareness within the company of the issues that need to be disclosed.<sup>163</sup> However, the researchers note that despite this new awareness, ‘[...] only a few interviewees made a connection from the reporting process back into the process of strategic

<sup>158</sup> ‘it is unclear as to whether social disclosure can actually change corporate behavior... research on the utility of social disclosure obligations has been inconclusive.’ In Choudhury 2016, *supra* note 16, p. 207; Also Buhmann 2017, *supra* note 10, p. 14.

<sup>159</sup> Cho *et al.* 2015, *supra* note 153, p. 28. See also P. M. Clarkson *et al.* 2008, *supra* note 156, who report similar findings. Choudhury in this regard notes: Even where negative information is disclosed, the information can be marginalized or abstracted in such a way that its focus is on altering stakeholders’ perceptions rather than changing corporate behavior. See Choudhury 2016, *supra* note 16, p. 209.

<sup>160</sup> M. Mitchell *et al.*, ‘Can triple bottom line reporting become a cycle for “double loop” learning and radical change?’ 25 *Accounting, Auditing & Accountability Journal* 6, 2012, pp. 1048 – 1068.

<sup>161</sup> As identified by Argyris and Schon and reiterated by Herrbach and Gond. However, Mitchell *et al.*, do not use the exact theory by Herrbach and Gond.

<sup>162</sup> ‘The triple bottom line (TBL) is a catchphrase [...] to help conceptualise sustainability as a three-pronged pursuit of “economic prosperity, environmental quality and social justice”. The authors stress that ‘In terms of learning outcomes, our analysis focused on whether our collaboration with MI on its TBL reporting project led to learning that was “single loop” or “double loop” in character.’ In Mitchell *et al.*, 2012, *supra* note 160, p. 1056. Thus, their main question focussed on the impact of their collaboration on the corporate learning process during the two-year reporting process. However, in their conclusions, they do not reiterate this focus and they do not actively link their collaboration to the outcomes.

<sup>163</sup> One of the interviewed company staff members indicated ‘In order to be able to put something in the annual report, you need the information. And in order to get the information, you need your systems. And in order to have your systems set up, you need to question what you do, and why you do it and how you do it and that’s how the circle I think is completed. (Staff 8).’ In Mitchell *et al.*, 2012, *supra* note 160, p. 1056.

planning.’<sup>164</sup> An interviewed manager in this regard responded “triple bottom line reporting is reporting on the results of our strategic direction [ . . . ] which is set by the Board” and thus asserting that TBL reporting had no role in helping to determine MI’s future strategic direction.’<sup>165</sup> Importantly, in terms of impact on decision-making, it was indicated that ‘When considering options in how to respond to major issues arising from TBL reporting, the MI Executive found that external influences had a much greater bearing on outcomes than internal management options.’<sup>166</sup> Observed changes to core operational principles within the two years, such as improved water efficiency aspects, could not be exclusively linked to the reporting process: these changes would have been implemented ‘regardless’ and were primarily attributable to external pressures, related to water security in light of the extreme drought the Australian based company was facing during the research period.<sup>167</sup>

Thus, this case confirms the prediction by Choudhury and the preparers of the Directive’s impact assessment, that information collection for reporting, helps reflect the companies on their current practices and leads to a ‘new awareness’.<sup>168</sup> However, it also indicates that this reflection alone is not sufficient to enable change: external pressures in this case lead to the more ‘radical’ changes in the board’s strategy. Finally, the researchers indicated the lack of external stakeholder engagement throughout the reporting process as a key constraint in their research.<sup>169</sup> The only external stakeholders involved in dialogue with the company were the company’s shareholders.<sup>170</sup> Therefore, they could not verify this aspect of social learning as described in OL theory.<sup>171</sup>

Finally, it should be noted that the study did not emphasize a disclosure element of the reporting process. The impact of the threat of a form of corporate accountability through disclosure on decision-making therefore was not verified. The circumstances of the research therefore do not lend themselves to an evaluation of the practicalities of reporting as reflexive law within the researched context.

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<sup>164</sup> *Id.*, p. 1057.

<sup>165</sup> *Id.*, p. 1057.

<sup>166</sup> *Id.*

<sup>167</sup> *Id.*, p. 1059: ‘Preventing unintended water losses was also emphasised by both channel attendants interviewed as critical to how their work performance would be assessed in the future. However, it is difficult to specify whether these developments resulted from the incorporation of TBL indicators into how MI assessed its performance. These changes would have been implemented regardless of the development of TBL objectives and indicators, or, indeed, the BSC corporate plan.’

<sup>168</sup> ‘One example is from Manager 1 who commented that TBL reporting is not just about “patting ourselves on the back and saying what a good job we’re doing” but that it also helps to “highlight flaws that not just us as a company but our area [the MIA] needs to concentrate on more”.’ *Id.*, p. 1057. And: ‘Manager 1, who responded in terms of the ability to continually improve – “just raising the bar of what we do” – which was then linked to individual changes of “a new awareness”.’ *Id.*, p. 1059.

<sup>169</sup> ‘While opportunities existed for internal stakeholders to take initiative in deciding future workplace strategies that could influence TBL outcomes, there was less potential for this activism to lead to a more radical questioning of MI’s overall corporate direction.’ *Id.*, p. 1060. The researchers added: ‘despite our most strident efforts to focus the organisational thinking towards external stakeholder engagement, during our period of engagement this remained a future commitment, and there was no indication how this would result in a change in the organisation’s system of governance.’

<sup>170</sup> *Id.*, p. 1061.

<sup>171</sup> Although the researches did not observe the ‘radical’ change which testifies of a social learning process as understood in OL, they concluded their work by expressing their hope that small, ‘incremental’ changes (as occurring within social adaptation) could be perceived as ‘as achievements that may be part of a broader movement for change [...] “several small changes in the aggregate can approximate those of a radical transformation”, especially where the changes are “moving in a similar direction”.’ *Id.*, p. 1062.

### 3.3 Sub conclusions

This chapter showed that while there are many studies on CSR disclosure, there are no studies that indicate an exclusive correlation between reporting on social issues and incorporation of these issues into corporate decision-making. This means that based on the research available, regulators that wish to use mandatory reporting as the main or only tool to enhance business respect for human rights, cannot yet rely on an evidenced effectiveness of this approach. Furthermore, studies that assess the impact of a company's stakeholders actions on decision-making do not support a strong reliance by the legislators on these stakeholders to drive change. This insight may have consequences for a review of the Directive as a form of reflexive law, and will be further discussed in the next chapter.

There is data available that shows that shareholders can impact human rights performance, which leads to a hypothesis that the economic pressure these stakeholders can exert, impacts decision-making. However, as the methodology that was used in this study is not publicly accessible, it could not be verified what other elements could have played a role in this correlation, besides the number of shareholder proposals.

It was furthermore observed that in the context of environmental performance, disclosure of extensive reports does not equate good performance. This suggests that disclosure of more information cannot automatically be linked to good performance, which can be taken into account in future research on the impact of the reporting requirements on the quantity and quality of disclosed information.

There is one study which was specifically designed to measure the impact of reporting to drive a social learning process within a company. The review of the study by Mitchell *et al.* showed that while voluntary reporting exercises displayed an awareness raising impact within the company, there was no strong link between this new awareness and changed decision-making. Rather, it was observed that external influences had a stronger impact on the board's strategy. Because not all elements which are described to drive change according to the social learning theory were present, the findings could not comprehensively validate or invalidate this theory.

## CHAPTER 4: DISCUSSION

This chapter brings together the findings of the previous chapters in order to answer the question how the EU could achieve its objective of stimulating responsible business conduct by changing the Non-Financial Reporting Directive to align with how theories of OL and literature on reflexive law explain that companies change their decision-making following reporting. As emphasized in the introduction, the exploration will highlight how reporting enables engagement between companies and the rightsholders, as rightsholders are deemed vital actors in the development of norms of responsible business behaviour. Therefore, the following discussion will link the learning points from the previous chapters to this aspect of responsible business conduct. Following the review of the theory of OL as put forward by Gond and Herrbach and reflexive law theory, the following main points of attention require closer examination by the EU legislator: 1) Social learning requires an interactive reporting process; and 2) A reporting indicator on stakeholder engagement is needed to enhance business respect for human rights and to attribute to the Directive a proper reflexive role. These two points will now be further discussed.

### 4.1 Social learning requires an interactive reporting process

It is clear that the Directive indeed needs to be adapted if it is to serve as a catalyst for change towards responsible business conduct: it currently lacks the mechanisms to do so. One of the reasons is that the Directive is not designed as an interactive reporting mechanism. When the legislator chooses a form of social reporting as a regulatory strategy to drive norm development in the field of business and human rights, the legislator should be aware of two main points in this regard which follow from the analysis on OL in chapter 2.

The first point is that a durable change of fundamental principles which inform corporate decision-making occurs through social learning, and not social adaptation; in order for reporting to encourage social learning, reporting should be an interactive process which involves the whole organization. Gond and Herrbach provided clues on what such a process should look like.<sup>172</sup> However, the Directive is clearly not designed to stimulate an interactive reporting process for the addressed entities. For example, it does not include any requirement which indicates who in the company should be involved with the information collection. It also does not include any requirements relating to how the information should be collected. Therefore, it cannot be assumed that the information collection will be an interactive process which is undertaken in several layers of the organization.

The second point is that social learning requires that issues which present the most relevant risks to human rights should be managed interactively by top management. The Directive does not mention top management involvement in the information collection as a prerequisite of compliance

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<sup>172</sup> See *supra* note 94 and 95.

with the reporting Directive. The EU should therefore explore how a reporting indicator can be adopted which requires companies to report which impacts were monitored by management interactively and which in a more diagnostic way. This is expected to provide better insight into how the reporting process stimulates management interaction with the collected information on human rights risks. For example, a suggestion could be to amend the Directive to include a requirement that asks of companies to describe how the undertaking involves top management to manage the described risks<sup>173</sup>, and what management has decided on the distinction between risks that require interactive management attention, and which risks require diagnostic management attention.

However, the reviewed study by Mitchell *et al.* demonstrated that even when reporting is undertaken as an interactive process, there is no guarantee that the reporting activities themselves lead to a change in decision-making. Notwithstanding that reporting activities led to a new ‘awareness’, the decisive events that lead to a change of corporate strategy of the researched company were external factors (in this case water scarcity), which would have led to a change in managerial decision-making regardless. Of course, the findings of the experiment by Mitchell *et al.* do not lead to a conclusion that a reporting process can never result in a change of corporate strategy, as their study took place within a specific set of circumstances.

The EU did acknowledge that, in order to achieve responsible business conduct, accountability through disclosure is needed too. The next paragraphs highlight the aspect of accountability through disclosure, in the arguments that will be presented on the importance of stakeholder engagement.

## 4.2 The Directive and the lack of stakeholder engagement

The impact assessment of the Directive purported that an improvement of quantity and quality of information can be used by ‘civil society organisations and local communities to assess the impact and risks related to the operations of a company.’<sup>174</sup> However, the legislators nowhere elaborated on the involvement of the mentioned stakeholders. Importantly, stakeholder engagement has not made its way as a formal requirement in the Directive. This will have a negative impact on the role that the Directive can play in improving business conduct, as will be explained in the following. In this regard, the following three points will be discussed in turn:

- 1) The lack of stakeholder engagement reduces the risk-preventative function of the Directive, as well as the Directive’s potential to stimulate a learning process for the reporting companies. This argument stems from the UNGPs’ guidance on the prevention of corporate human rights risks and the analysis of OL in chapter 2.
- 2) The lack of stakeholder engagement reduces the reflexive function of the Directive. This observation follows from the analysis of the literature on reflexive law in chapter 2. And;

<sup>173</sup> See Directive, *supra* note 1, art. 19a(d).

<sup>174</sup> Impact assessment, *supra* note 4, p. 38.

3) A resort to reflexive law requires a clear vision of the role of law in the steering of corporate behaviour. This argument equally follows from the analysis of the literature on reflexive law in chapter 2, as well as from the findings in chapter 3.

#### 4.2.1 The lack of stakeholder engagement, the risk-preventative function of the Directive and social learning

The lack of stakeholder engagement as a condition for the information collection of the non-financial statement reduces the Directive's risk-preventative function.<sup>175</sup> Buhmann highlighted that in order for the Directive to serve as a tool for the prevention of harm, stakeholder perceptions are to be included in the assessment of risks, as well as in relation to mitigation thereof.<sup>176</sup> As mentioned, although the Directive does not mention stakeholder engagement, the impact assessment did. In particular, the impact assessment mentioned a role for 'local communities' to assess risks that the company will disclose. It should be noted that, assuming that 'local communities' refers to impacted communities or 'potentially affected groups'<sup>177</sup>, the timing of their involvement is particularly relevant. For example, if the legislators aimed to empower local communities to engage with the corporate decision-making in accordance with the approach advocated in the UNGPs, their (meaningful) engagement should be assured already in the planning phase of a project.<sup>178</sup> However, lacking a requirement for companies to involve local communities as rightsholders in the information collection for the non-financial statement, the Directive in theory only gives impetus for a form of engagement post disclosure of the annual report. Therefore, it can be assumed that this engagement currently consists of the actions that the mentioned stakeholders (consumers and investors) could exercise via their economic leverage. It does require actual dialogue between those actors and the company. Such disclosure is thus unlikely to enable local communities to engage with the disclosing company throughout the year to prevent negative human rights impacts. Indeed, it can be noted that the formal reporting of impacts via the Directive should be distinguished from the communication requirements for human rights due diligence as stated in the UNGPs under pillar 2. Whereas human rights due diligence, and thus communication, in the latter occurs regularly and is required for every project<sup>179</sup>, the Directive simply requires the entities to report on how they conducted human rights due diligence. Therefore, when the impact assessment infers that the reporting will help stakeholders assess impacts and risks related to

<sup>175</sup> See the reasoning in the Impact assessment, *supra* note 4.

<sup>176</sup> 'for communication as part of HRDD and therefore non- financial reporting to serve the objective of prevention of harm, the process needs to be undertaken from a broader approach that emphasizes understanding stakeholder perceptions of impacts both before they occur, and after the firm has sought to address them.' In Buhmann, 2017, *supra* note 10, p. 14.

<sup>177</sup> Language used in the Guiding Principles, *supra* note 10.

<sup>178</sup> Guiding Principles, *supra* note 10, Principle 18 and accompanying commentary. 'Planning phase of a project' is used to refer to what the Guiding Principles describe as 'prior to a proposed business activity'.

<sup>179</sup> 'Assessments of human rights impacts should be undertaken at regular intervals: prior to a new activity or relationship; prior to major decisions or changes in the operation (e.g. market entry, product launch, policy change, or wider changes to the business); in response to or anticipation of changes in the operating environment (e.g. rising social tensions); and periodically throughout the life of an activity or relationship.' See Guiding Principles, *supra* note 10, Principle 17, Commentary.

the operations of a company<sup>180</sup>, it is questionable whether this holds true in relation to the assessment of risks.<sup>181</sup> Therefore, the EU legislators should reconsider whether they wish to design a reporting law in such a way that it enables the prevention of human rights impacts.

In addition to top management involvement in the reporting process, stakeholder engagement is crucial in a social learning process. Gond and Herrbach stressed that within the social learning approach, the engagement with the external social environment is viewed by an organization as an ‘opportunity’.<sup>182</sup> However, it should be noted that there might exist an inherent tension between the Directive’s objective of providing accountability towards stakeholders through disclosure (which aligns with reflexive law theory), and the need for a company to not see the external environment as a threat, following the explanation on social learning.

An illustration of this tension can be found in Buhmann’s work, who notes that the improvement of disclosure of non-financial disclosure could help inform complaints with the National Contact Points.<sup>183</sup> Legal and reputational liability are commonly perceived by companies as a threat.<sup>184</sup> A prospect of increased opportunities to inform complaints with the NCPs following disclosure through reporting may therefore interfere with efforts to change companies’ perception of the external environment from ‘threat’ to ‘opportunity’. This is relevant if a social learning process towards better risk-prevention through reporting should occur in collaboration with a company’s stakeholders.<sup>185</sup> A suggestion for future research would be to examine whether and how this tension between the objectives of providing transparency and providing accountability might impact the quantity and quality of the reporting, and if this impacts the learning process which is attached to the information collection.<sup>186</sup> In addition, the EU legislator could aim to design a reporting indicator on stakeholder engagement which mandates companies to enter into engagement and report on this, while taking into account issues of client confidentiality, and other transparency concerns that companies may have.<sup>187</sup> Again, it is important that further research clarifies which circumstances and interactions with the

<sup>180</sup> Language used in the Guiding Principles, *supra* note 10.

<sup>181</sup> See also Buhmann 2017, *supra* note 10. Risks here meaning ‘A business enterprise’s human rights risks are any risks that its operations may lead to one or more adverse human rights impacts. They therefore relate to its *potential* human rights impact.’ See United Nations (2014), Frequently asked questions about the guiding principles on business and human rights, HR/PUB/14/3 United Nations Publication, p. 43.

<sup>182</sup> *Supra* note 91.

<sup>183</sup> Buhmann 2017, *supra* note 10, p. 12.

<sup>184</sup> See also B. T. Cragg, ‘Home is Where the Halt Is: Mandating Corporate Social Responsibility through Home State Regulation and Social Disclosure’, 24 *Emory International Law Review*, 2010, pp. 735 – 775, p. 772.

<sup>185</sup> *Supra* note 5.

<sup>186</sup> The hypothesis exists that with an increased fear of legal liability, there will be a heightened need for detailed legal reporting requirements, in order ensure legal certainty for the companies, and to ensure quality of reporting. As put forward in conversation with Remco Slim, Project Strategy Manager at Sustainalytics, a global ESG research firm..

<sup>187</sup> The ABN AMRO indicate as a reporting dilemma that they do not report on their client relationships with third parties. See ABN AMRO, Responsible banking in practice. Human Rights Report 2016, p. 26. Last accessed 8-8-2018 via [https://www.abnamro.com/en/images/Documents/040\\_Sustainable\\_banking/080\\_Reporting/2016/ABN\\_AMRO\\_Human\\_Rights\\_Report\\_2016.pdf](https://www.abnamro.com/en/images/Documents/040_Sustainable_banking/080_Reporting/2016/ABN_AMRO_Human_Rights_Report_2016.pdf) Client confidentiality is presents a reporting dilemma across the finance sector. Law firm NautaDutilh has investigated the possibilities for increased transparency on human rights due diligence practices in light of Dutch banks’ (legal) confidentiality obligations towards Dutch clients. The law firm set out the regulatory and civil law constraints on increased transparency, as well as any contractual limitations. See <https://www.imvoconvenanten.nl/~media/files/imvo/banking/news/nautadutilh-legal-report.ashx>.

external environment (including rightsholders) of a company relate to perceptions of ‘threats’ and ‘opportunities’. In addition, it could be explored whether there are factors which can change the company’s perception of an external circumstance as a ‘threat’ into an ‘opportunity, thereby triggering the change from the social adaptation process, stimulated by external pressure, into a social learning process.<sup>188</sup>

#### 4.2.2 The lack of stakeholder engagement and the reflexive function of the Directive

Reporting legislation, as a form of reflexive law, can provide the procedural mechanisms under which companies are directed to internalize stakeholder views into their decision-making processes. Such mechanisms can moreover serve to ‘equalize bargaining positions’ between a company and external actors, by redistribution of information. The review of Teubner’s reflexive law theory in chapter 2 clarified how the law can intervene in the bargaining process between parties where power asymmetries so demand. Unfortunately, it is rather difficult to ascertain from the text of the Directive what kind of bargaining process it could impact. Mainly because the Directive doesn’t require the addressed entities to include rightsholders’ (and other stakeholders) views in the information collection for the assessment (and mitigation) of human rights risks, it is improbable that the Directive directly intervenes in the bargaining position of parties in relation to agreement on the (norms of) actual company operations. After all, during due diligence processes, decisions are expected to be made on the design criteria of operations which could impact the enjoyment of human rights.<sup>189</sup> The question rises what type of bargaining process the legislator in fact seeks to steer, and more specifically, the bargaining process between which actors.

It is not unthinkable that following disclosure of the non-financial statement, stakeholder engagement will take place between the disclosing entities and other stakeholders. For example, when certain stakeholders disagree with an adopted due diligence process of a company, they could enter into dialogue with the company, and thereby in theory impact the design of future due diligence processes. It appears that this is indeed the rationale of the EU legislator.<sup>190</sup> As companies are only required to include the non-financial statement since 2018, it remains to be seen how the disclosure in the annual reports redistributes information and what the impact will be on the leverage of different stakeholders to impact norms of corporate conduct. However, although accountability is a fundamental premise upon which the Directive’s effectiveness is based, the EU’s reliance on investors and consumers to drive change is not rooted in an evidenced effectiveness.

Therefore, the EU should explore the possibilities of the inclusion of a reporting criterion that requires companies to engage with rightsholders and other stakeholder for the information collection

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<sup>188</sup> As literature describes different impacts according to different philosophies, further research could analyse what impact different management philosophies may have on the perception of ‘threats’ and ‘risks’ and thereby on the learning process. For example, Vitolla *et al.*, describe competing interests that require management attention, in accordance with different management philosophies. See Vitolla *et al.* 2017, *supra* note 79, p. 101.

<sup>189</sup> See previous discussion point.

<sup>190</sup> See the introduction and chapter 1.

of the statement, and to report on the conducted engagement. Of course, the possible constraints of such a criterion need to be explored as well, as emphasized in the previous discussion point. However, such a criterion could be a start to realign the Directive with the purpose of reflexive law, as it would provide an expression of the reflexive function of law to equalize bargaining power between regulated parties, without interfering in the ultimate agreement by prescribing the desirable outcome of the bargain. In addition, such a criterion would mandate the internalization of externalities in the decision-making of the public-interest entities. However, such an amendment requires a clear vision of the role of law, as will be elaborated in the following.

#### 4.2.3 A resort to reflexive law requires a clear vision of the role of law

In the beginning of this thesis, it was mentioned that reporting is a preferred regulatory tool, *inter alia* because it is expected to steer company behavior notwithstanding a lack of consensus regarding the role of government to prescribe, or intervene, in corporate decision-making.<sup>191</sup> However, in this paragraph it will be argued that the use of reporting to steer responsible business conduct, does require consensus on the role of governments to intervene in company behaviour.

The need for stakeholder engagement in the framework of social learning raises the question how dialogue can be stimulated in a way that includes all relevant stakeholders' views; so that future negative impacts are prevented in a way that incorporates the views of the most marginalized rightsholders too, in line with the specifications of human rights due diligence as described in the UNGPs.<sup>192</sup> While the reviewed OL theory did not emphasize the importance of accountability through public disclosure in this regard, reflexive law theory does. Studies that look at incentives for companies to incorporate stakeholder views into their decision-making point towards economic leverage of the actors as being decisive in this regard.<sup>193</sup> If it holds true that incorporating stakeholder views into corporate decision-making depends on the economic relevance of such views, there is a possibility that those actors whose economic situation is irrelevant to the corporate actor, will not be

<sup>191</sup> *Supra* note 35.

<sup>192</sup> Guiding Principles, *supra* note 10, Principle 17, under Commentary.

<sup>193</sup> FASTERLING highlights the pressure that shareholders could exert via the general shareholder meetings, as well as via the capital market, where shareholders' opinions should become apparent: FASTERLING who writes about norm development through 'compliance disclosure'. Compliance disclosure is described as a 'regulatory technique whereby companies are obliged to disclose the extent to which they comply with codes, 'best practice standards' or other extra-legal texts containing norms or prospective norms.' Whilst the Directive does not strictly represent compliance disclosure, FASTERLING notes that the suggestions he makes could be applied to the field of business respect for human rights too. He furthermore notes that his theory resonates with HESS' reflexive law. Therefore, this literature could provide relevant insights for the adaptation for the Directive. See FASTERLING 2012, *supra* note 31, p. 73, p. 75 and p. 85. WEIL *et al.*, describe an 'action cycle' where they analyse how new information impacts corporate behaviour by becoming an 'intrinsic part of the decision-making routines of users and disclosers'. This action cycle relies on the relevance of the information user's actions following disclosure to the information discloser. Market and political incentives are mentioned in this regard. Importantly, and related to previous emphasis on economic incentives, it is stressed that 'disclosers change their practices only if they perceive that shifts in user behaviour have an impact on core organizational goals. That is, to become embedded in disclosers' decisions, they must sense that user actions will substantially affect their interests or be likely to do so in the near future. For private sector managers, core objectives often include improving profitability, market-share, and reputation.' See D. WEIL *et al.*, 'The Effectiveness of Regulatory Disclosure policies', 25 *Journal of Policy Analysis and Management* 1, 2006, pp. 155-181.

heard. For example, it might be that some affected rightsholders, due to their marginalized position within a group, are never in the position to oppose a project in such a way that their opposition will result into delay costs for a company: costs which are recognized as establishing a ‘business case’ for respect for human rights.<sup>194</sup> Here, it is expected that an asymmetry in bargaining power between a company and these rightsholders will persist. Furthermore, although a business case for business respect for human rights may exist, it can be questioned whether ‘respect for human rights’ always guarantees higher returns for a company.<sup>195</sup> Such a potential consequence of a reliance on the functioning of the market reminds one of the duty of States to protect human rights and the connected duty to use their regulatory and policy functions to guarantee the protection of rightsholders.<sup>196</sup>

The review of reflexive law theory demonstrated that a resort to reflexive law may require an institutional intervention in this regard. However, the Directive’s reporting strategy does not testify of an aligned vision of the EU legislators with the vision that Teubner and Hess advocated regarding the role of reflexive law in the advancement of responsible business conduct. The absence of an explicit reference to rightsholders, in combination with the appearing assumption that economic leverage determines to what extent stakeholders’ views are internalized in corporate decision-making, results in a presumption that thus far, the EU relies on accountability through the market to advance norms of responsible business conduct. This is not desirable, for reasons elaborated above.<sup>197</sup> The EU should therefore reflect well on the vision that it holds of the role of law in the advancement of responsible business conduct. In addition, the EU ought to reflect well on the normative concepts of what constitutes a just society: theories thereof compete with each other and ‘serious consequences emerge for law’.<sup>198</sup> Only when the EU formulates a clear vision of the desirability and extent to which rightsholders (and other stakeholders) hold a bargaining position in the formulation of norms of

<sup>194</sup> For a clear explanation with examples of the business case for CSR, see: R. Davis and D. M. Franks (2014), *Costs of Company-Community Conflict in the Extractive Sector*. Corporate Social Responsibility Initiative Report No. 66. Cambridge, MA: Harvard Kennedy School.

<sup>195</sup> For example, a company might be forced to retreat from conducting business in a certain country where respect human rights cannot be guaranteed due to the political country context. A. B. Carroll and K. M. Shabana, ‘The Business Case for Corporate Social Responsibility: A Review of Concepts, Research and Practice’, 12 *International Journal of Management Reviews* 1, 2010, pp. 85-105, p. 93. At the same time, a research gap has been identified: It has been noted in recent management research that ‘The relationships between CSR and financial results are investigated following an instrumental logic which considers CSR as a means, albeit innovative, for the maximization of profit. There is a lack of meaningful contributions which analyse the strategic integration of CSR, based, in a systematic way, on a socially oriented management philosophy, acknowledging the twofold function (both economic and social) of the companies, not placing profit as a super-ordinate hierarchical position.’ In: Vitolla *et al.*, 2017, *supra* note 79, p. 90.

<sup>196</sup> Whilst an elaboration on a business case for human rights stretches too far for this thesis, it can be observed that the emphasis on the need for the existence of such a business case to induce organisational learning, could be contrasted with arguments for a moral duty to enhance responsible corporate conduct. Weil *et al.* 2006, *supra* note 193, p. 80. Referring to Stevens, J. M., Steensma, H. K., Harrison, D. A., & Cochran, P. L. (2005). Symbolic or substantive document? The influence of ethics codes on financial executives’ decisions. *Strategic Management Journal*, 26, 181–195., Weil *et al.*, note: ‘where an ethics code is applied to financial executives, when market stakeholders such as suppliers, customers or shareholders do not exert pressure, these executives implement their code symbolically rather than substantially.’

<sup>197</sup> See also G. Teubner *et al.*, ‘The Autonomy of law: An introduction to legal Autopoiesis’ in James Penner, David Schiff and Richard Nobles (eds) *Jurisprudence* (New York: Oxford University Press, 2005), p. 936.

<sup>198</sup> See the discussion on reflexive theories (economic theories and political theories) in G. Teubner *et al.* 2005, *supra* note 197, p. 936.

business conduct, can reporting requirements be refined to properly intervene in the bargaining positions of businesses and rightsholders. This can be deduced from Teubner's explanation that 'in the case of "interaction deficiencies" between contracting parties, objective purposes and duties are defined authoritatively by virtue of law.'<sup>199</sup> A vision of the objectives of law may therefore simultaneously align with another vision: the scope of the desirability of institutional intervention in corporate decision-making, and more specifically, the desirability and practicality of the EU as an international organization to do so. A comprehensive review of the Directive by the regulators should include a discussion in that regard.

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<sup>199</sup> Teubner 1983, *supra* note 17, p. 278.

## FINAL CONCLUSION

This thesis discussed the following question: how could the EU achieve its objective of stimulating responsible business conduct by changing the Non-Financial Reporting Directive to align with how theories of OL and literature on reflexive law explain that companies change their decision-making following reporting? This is an important question, as state encouragement of external communication stimulated by the UNGPs.<sup>200</sup> In addition, reporting is a preferred regulatory tool by States to steer corporate conduct in the field of business and human rights. The law holds an important role in the future norm development in the field of business and human rights: after all, the law establishes the ‘structural premises for future decisions in terms of organization, procedure, and competencies’.<sup>201</sup> The impact of reporting legislation on corporate decision-making is therefore crucial to understand.

To understand how reporting can impact corporate decision-making, OL theory was consulted. The review of Herrbach and Gond’s writing on OL showed that social learning, rather than social adaptation, is needed to drive a durable learning curve in the responsibility principles that inspire the decision-making of the company. It was pointed out that to guide the social learning process, top management attention is required in relation to the issues that require change. This is the first learning point the EU legislators should consider if they wish to improve the Directive: top management attention finds expression in an interactive, rather than diagnostic, control system of information for the purpose of social reporting. The Directive thus needs to be reviewed with the purpose to stimulate such an interactive control system in the reporting companies.

However, while top management awareness of information is crucial, it was confirmed that a new awareness of issues alone may not be sufficient to drive change. This is where the aspect of accountability through increased transparency comes into play, as recognized by the EU. However, a tension was observed between the need for companies to see the social external environment as an ‘opportunity’ to engage with within the social learning approach, and the use of reflexive mechanisms which link a bargaining process between a company and the external environment to ‘mechanisms of public responsibility’. Further research in this regard is needed to understand company’s perceptions of the external environment. Specifically, company’s perceptions of a ‘threat’ or ‘opportunity’ and the impact of these perceptions on the effectiveness of the Directive in achieving its objectives.

Reflexive law theory sets out how the law can steer the internalization of externalities into the company’s decision-making, thereby equalizing bargaining positions of actors. Stakeholder engagement for the purpose of information collection was highlighted within Hess’ explanation of reporting as reflexive law. Without mandated stakeholder engagement, the legislators failed to acknowledge the Directive as a use of reflexive law, now that it is less clear which bargaining parties

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<sup>200</sup> *Supra* note 43.

<sup>201</sup> Teubner 1983, *supra* note 17, p. 275.

are targeted by the Directive. From the review of studies in chapter 3, it follows that the EU should not rely on the economic leverage of actors to influence corporate-decision making. Firstly, because the effectiveness of this leverage is not straight-forward. Secondly, because such an approach will always exclude stakeholders' views whose economic position is irrelevant to the company. Such an approach does not align with the UNGPs, which empower rightsholders through their participation in human rights due diligence. Where systematic asymmetries in bargaining power persist, reflexive law theory by Teubner asks for institutional intervention. Therefore, if the EU wishes to use reporting as a regulatory tool to drive responsible conduct to align with how theories of OL and literature on reflexive law, the Directive needs a reporting indicator which requires companies to engage in stakeholder engagement for the purpose of information collection. Missing such a mandatory requirement, it is unlikely that complying with the Directive will steer companies in a social learning process in collaboration with stakeholders, including rightsholders.

In this regard, a recourse to reflexive law requires a clear vision of the desirability of institutional intervention in the bargaining positions of parties. Now that the Directive lacks the mechanisms to equalize bargaining positions between rightsholders and companies, the EU does not implement a vision of responsible business conduct which matches the spirit of the UNGPs. Furthermore, although the Directive is an example of the use of reflexive law, unfortunately, to use Teubner's wording, this is a very 'shaky' one.<sup>202</sup>

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<sup>202</sup> Teubner 1983, *supra* note 17, p. 277.

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