

Implications of “*Directive on Disclosure of Non-Financial and Diversity Information*” on Croatian Companies’ Reporting System

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Abstract. Implementation of Directive on disclosure of non-financial and diversity information in EU member states represents the first step in making this segment of reporting mandatory. Although, only some companies (mostly the largest undertakings and public interest entities) will be obligated to issue non-financial reports, the number of disclosed reports on corporate social responsibility and sustainability issues is expected to increase significantly. The Croatian Accounting Act has been adjusted to the requirements of this Directive, thus the non-financial reporting has become mandatory in Croatia, at least for some companies. However, compared to some other EU member states the number of companies obligated to prepare the non-financial report is higher due to wider definition of public interest companies. Currently, only a small proportion of Croatian companies disclose non-financial reports on voluntary basis. These are mostly large companies operating in manufacturing sector. However, the number of issued non-financial reports will increase in year 2017 as a result of mentioned Directive implementation.

Keywords: non-financial reporting, corporate social responsibility, Directive, Croatia

1 Introduction

The importance of corporate social responsibility (CSR) is constantly increasing. In order to manage CSR successfully, information on this issue are required. Such information should be provided by the social responsibility accounting, which is a special segment of accounting. Social responsibility accounting by definition represents “the process of selecting firm-level social performance variables, measures and measurement procedures; systematically developing information useful for evaluating the firm’s social performance; and communicating such information to concerned social groups, both within and outside the firm” (Ramanathan, 1976, 519). Although, social responsibility accounting is still in its developing phase, it is expected that its importance will grow in the future. The main output of this accounting segment should be non-financial reports, prepared for the variety of internal and external users. Non-financial reporting is often referred as sustainability reporting or corporate social responsibility reporting.

The regulatory bodies of EU have also recognized the importance of CSR and non-financial reporting covering this issue. Consequently, the “Directive on disclosure of non-financial and diversity

information by certain large undertakings and groups”¹ (herein after: Directive 2014/95/EU or “Non-Financial Reporting Directive”) has been developed and accepted. Directive requires disclosure of information on environmental, social and employee aspects, respect for human rights, anticorruption and bribery issues, and diversity in their board of directors, from certain, mostly, larger companies. According to the Directive, large, public-interest companies, with more than 500 employees in average, will be obligated to include non-financial information in their management report. Respective Directive had to be implemented into national legislation of EU member states until the end of year 2016, whilst first reports in line with Directive should be prepared for financial year 2017.

Aim of this paper is to explore the possible implications of “Non-Financial Reporting Directive” transposition into Croatian legal system on the existing reporting system of Croatian companies. At the moment, non-financial reporting on CSR issues by Croatian companies is very poor. However, the non-financial reporting will increase in the future, mostly due to Directive implementation and shift to the mandatory disclosure of non-financial information, at least for some companies.

Based on exploring the Directive provisions and its implications on existing reporting system, conclusion on further development of this segment reporting will be provided, as well as recommendation on how to comply with Directive requirements. Taking into account limited experience in non-financial reporting in Croatia, the main challenge for companies will be to prepare and disclose the first non-financial report. To meet the Directive’s requirements, companies should invest in education of employees who will be in charged to prepare and disclose non-financial reports. This will certainly result in additional costs for company. Additionally, Chamber of economy or Development agencies should organize supporting instruments, such as workshops and seminars on non-financial reporting.

The paper starts with literature review on CSR and non-financial reporting. Afterward, the legal framework on non-financial reporting is explained in details, followed by presentation of guidelines for non-financial reporting issued by European Commission. At the end of the paper, the current state of non-financial reporting in Croatia is presented and finally, the discussion and conclusions remarks are presented.

2 Literature Review

Contemporary business requires also contemporary ways of running a business. For a long period of time the principal aim of running a business was to increase company’s profit. However, time has changed. The increase of profits still remains a very important motive of running a business, but not the only one. The interest of other stakeholders, not just shareholders, is considered as well. Thus, when running a business the needs of larger groups of stakeholders should be taken into account.

The stakeholder concept was first introduced by Freeman in 1984. According to him, it is important to “take into account all individuals and groups with a “stake” in or claim on the company” while running a company (Melé, 2009, 62). Since Friedman’s definition of stakeholders included only humans, Starik (1995) extended this coverage of stakeholder definition to “any naturally occurring entity which affects or is affected by company’s performance”. Thus, the stakeholder concept covers also non-humans such as natural environment.

¹ 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, OJ L 330, 15.11.2014, p. 1–9.

The concept of considering interests and needs of larger group of stakeholders, instead of just focusing on interests of shareholders, is known as the concept of corporate social responsibility (CSR). The most commonly cited definition of CSR is provided by Davis (1973, 312), who defines CSR as “the firm’s considerations of, and responses to, issues beyond the narrow economic, technical, and legal requirements of the firm to accomplish social (and environmental) benefits along with the traditional economic gains which the firm seeks.” Besides this definition, large number of CSR definitions can be found in literature. Dahlsrud (2008) identified 37 different definitions of CSR. Taking into account different definitions of CSR, Springle & Mines (2010, 445) proposed the following definition “CSR represents voluntary company endeavors which benefit society”. By being socially responsible, companies contribute to sustainable development, according to which the process of satisfying the needs of present generations should not compromise the possibility of future generation to meet their own needs (UN, n.d.).

Being socially responsible means certain benefits for a company. The effects of CSR on financial performance has been studied for a while. Although, there is no common conclusion whether the effects of CSR on CFP are positive, negative or neutral, the findings of several meta analysis and extensive literature review reveal that positive results dominate (Wu, 2006; Lu et al, 2014; Orlitzky et al, 2003; Margolis and Walsh, 2001; Van Beurden and Gössling, 2008). Galbreath (n.d.) found that CSR reduces employee turnover and improves customer satisfaction. Focusing in accounting view of CSR, Springle and Mines (2010) list the following benefits of CSR: tax deductions, “free” advertising, a means for attracting, motivating, and retaining talent, efficiencies and cost savings in the value chain and positive effects on consumers’ purchasing behaviours.

The importance of the CSR concept has been recognized by European Union as well. European Commission defines CSR as following “CSR concerns actions by companies over and above their legal obligations towards society and the environment” (European Commission, 2011). While emphasising the importance of CSR, European parliament and Council have issued the Directive on non-financial and diversity reporting (Directive 2014/95/EU). Thus, reporting on CSR (i.e. non-financial reporting) becomes obligatory in EU member countries, at least for some companies. Directive 2014/95/EU is elaborated in details in the following chapter of the paper. According to Global Reporting Initiative (GRI) companies may expect the following benefits of non-financial reporting: building trust, improved processes and systems, progressing vision and strategy, reducing compliance costs, competitive advantage (GRI, n.d.). In addition, Dhaliwal et al (2011) found that companies enjoy subsequent reduction in cost of capital by issuing non-financial report.

Compared to financial reporting, the non-financial reporting is less developed in terms of standardization and harmonization. Different standards and initiatives for the development and promotion of non-financial reporting have arisen. The most important initiatives of this kind are: Global Reporting Initiative (GRI), UN Global Compact, ISO 26000, AccountAbility’s AA1000, OECD guidelines for multinational enterprises.

Global reporting initiative (GRI) represents an organization that aims to promote sustainable development by defining a sustainability reporting framework in form of guidelines for disclosing. UN Global Compact is “a leadership platform for the development, implementation and disclosure of responsible and sustainable corporate policies and practices” (UN Global Compact, n.d.). Organization taking part of UN Global Compact are required to issue an annually based report (“Communication on progress”) indicating the progress made in implementing the UN Global Compact ten principles in the field of human rights, labour, environment and anti-corruption. ISO 26000 – Social responsibility provides standards on how organizations should operate in socially responsible way (ISO, n.d.). AccountAbility’s AA1000 includes a series of standards that represent “the principles-based standards to help organization become more accountable, responsible and sustainable” (AccountAbility, n.d.).

The OECD Guidelines for Multinational Enterprises provide non-binding principles and standards for responsible business conduct of a company in a global context consistent with applicable laws and internationally recognised standards (OECD, n.d.).

Besides international standards/guidelines for non-financial reporting, European Commission in July 2017 has issued its own guidelines on non-financial reporting (methodology for reporting non-financial information). More on this guidelines in next chapters.

Considering further standardization of non-financial reporting, Tschopp and Nastanski (2014) consider that GRI guidelines would be the best standards solution in providing useful information regarding CSR/sustainability.

3 Legal Framework

The regulatory bodies of EU have recognized the importance of CSR and reporting on it. Thus, they have issued a “*Directive on disclosure of non-financial and diversity information by certain large undertakings and groups*” which had to be implemented into national legislations of EU member states until the end of the year 2016 (see: Art. 4, Directive 2014/95/EU).

3.1 Directive on disclosure of non-financial and diversity information

In this paper we analyse only those provisions of respective Directive that are concerned with the obligation to issue a report on non-financial information. Accordingly, we do not analyse those provisions that regulate so called “diversity information”, i.e. Art. 1(2), Directive 2014/95/EU, amending Art. 20, Directive 2013/34/EU.

Legal background

During the year 2011, The EU Commission has issued two documents concerned with corporate social responsibility and transparency. First one was called “*Communication on Single Market Act – twelve levers to boost growth and strengthen confidence - Working together to create new growth*” issued on April 13th 2011)² and the second one was called “*Communication on a renewed strategy 2011 – 2014 for Corporate Social Responsibility*” (issued on October 25th 2011)³. On the other side, on February 6th 2013, The EU Parliament issued two resolutions that acknowledged the importance of corporate social responsibility and transparency: “*Corporate Social Responsibility: accountable, transparent and responsible business behaviour and sustainable growth*”⁴ and „*Corporate Social Responsibility: promoting society’s interests and a route to sustainable and inclusive recovery*”⁵. Furthermore, numerous meetings of expert groups were held in order to analyse the need for mandatory non-financial reporting in certain companies (11.07.2011, 12.09.2011, 30.09.2011, 24.01.2012),⁶ the Public Consultations were held on the same topic, and finally, CSES - Centre for Strategy and Evaluation Services issued a “*Study on the disclosure of non-financial information by companies*”⁷. All those

² COM/2011/0206 final

³ COM/2011/0681 final

⁴ Available at: <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-49>

⁵ Available at: <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P7-TA-2013-0050&language=EN>

⁶ See: http://ec.europa.eu/finance/company-reporting/non-financial_reporting/index_en.htm#related-information-communications

⁷ Available at: http://ec.europa.eu/internal_market/accounting/docs/non-financial-reporting/com_2013_207-study_en.pdf

Expert Meetings, Studies and Public Consultations showed that there certainly is a need for mandatory non-financial reporting in certain companies, but only under certain conditions. Consequently, on April 15th 2014, The EU Parliament adopted *the draft version of The Non-Financial Reporting Directive*⁸ which has been adopted by the Council of EU on September 29th 2014. Finally, on October 22nd 2014, The EU Parliament and The Council of EU adopted the final text of respective Directive.

It is important to notice that final text significantly differs from the original (i.e. the draft version of Directive). Namely, the strongest opponents against Directive were: Germany (see: German Federal Government Position Paper, 2011); undertakings and their associations from all over EU (such as: BusinessEurope and EuroChambers); and, especially, undertakings and business associations from Germany (see: BDA, BDH, DIHK and ZDH, 2011). A respective reaction is quite reasonable if we bear in mind that the backbone of German economy is consisted of so called medium-sized companies, which should have been affected by non-financial reporting according to original text of Non-financial Reporting Directive (Kinderman, 2015, 10). Accordingly, by opposing the Directive, Germany tried to defend its economy driving force from additional costs and additional legal and administrative burden (Kinderman, 2015, 9 – 11). The main argument of Germany and German undertakings against mandatory-non financial reporting may be summarized in citing following quotation: “*Companies engage themselves voluntarily in highly diverse areas – consequently, whether and how they report should also remain voluntary. The bureaucratic burden – especially for small and medium-sized companies – would be considerable and greatly outweigh any benefits*” (BDA, BDI, DIHK and ZDH, 2011:2, as cited in Kinderman, 2015, 6). Similarly, the BusinessEurope and EuroChambers stated that non-financial reporting must be voluntary and exclusively business-driven. Accordingly, companies themselves shall decide whether they want to report on their non-financial activities, in which extent, and in which way they will do it. In contrary, mandatory non-financial reporting is likely to provoke significant costs and administrative burden that undermine their strength and competitiveness. Furthermore, reporting on non-financial information shall stay voluntary. Otherwise, it will turn into another box-ticking obligation (Kinderman, 2015, 5 – 6).

On the other side, the strongest Directive supporter was France. The other supporters, but not such prominent as France, were United Kingdom, Denmark, Belgium and Netherlands (Kinderman, 2015, 9). It is important to notice that France, UK, Denmark and Sweden⁹ were only EU member states that provided mandatory non-financial reporting even before Directive entered into force.¹⁰ Finally, UK had proposed several amendments to original text of Directive, which have been accepted by other EU member states and, accordingly, incorporated in the final text of Directive. Consequently, the final text is substantially enervated in relation to original text provided by the draft version of Directive. Here we will present the most important amendments into the original text of Directive.

Final text – amendments

1.) According to initial proposal, Directive should have been applied to all companies with over 500 employees. Consequently, it should have been applied on approximately 18.000 companies all over EU. Nevertheless, according to final text, it applies only to large, public interest companies, with more than 500 employees. Thus, it is expected to encompass 6.000 companies all over EU (approximately).

⁸ COM/2013/0207 final - 2013/0110 (COD)

⁹ Before Directive 2014/95/EU entered into force, Sweden had provided mandatory non-financial reporting only for state-owned companies (FEE, 2016, p. 3).

¹⁰ For more information about correlation between national legislations that provide mandatory non-financial reporting and Directive supportiveness see infra „*National legislations across EU and Non-financial Reporting Directive*“.

2.) According to final text of Directive, the non-financial statement may be provided in a „*separate report*”, separated from the management report, if national laws provide so. It means that so called “*integrated reporting*” is no longer “*a must*”, as it was under the draft text of Directive.

3.) According to final text of Directive, a so called „*safe harbour clause*” may be provided by national laws. It means that in accordance with certain circumstances, companies may be exempted from the obligation to disclose non-financial information. Such opportunity was not provided by original text of Directive.

Transposition period and Transposition Results

All EU member states were obliged to harmonize their national laws with Directive until December 6th, 2016 (Art. 4, Directive 2014/95/EU). Furthermore, The EU Commission was obliged to prepare non-binding guidelines on methodology for non-financial reporting until December 6th, 2016 (Art. 2, Directive 2014/95/EU).

According to information available on official EU website¹¹ (last visited on June 30th 2017) 24 member states have implemented Directive in their national laws, including Croatia. Nevertheless, 4 member states did not implement the Directive in their national laws, yet. Those states are: Belgium, Ireland, Spain and Portugal.

Since „*the transposition period*” lasted until the end of 2016, first non-financial reports made in accordance with Directive are going to be done for year 2017. Accordingly, we expect them in year 2018.

Directive 2014/95/EU – ratio legis

Technically, Directive 2014/95/EU is aimed to amend “*Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain undertakings*”¹², which amends Directive 2006/34/EC¹³ and repeals Directives 78/660/EEC¹⁴ and 83/349/EEC¹⁵.

As strictly stated into Recital of Directive 2014/95/EU, the **objective** of Directive 2014/95/EU is to: „(...) *increase the relevance, consistency and comparability of information* (non-financial information, op. a.) *disclosed by certain large undertakings and groups across the EU (...)*”¹⁶

Broadly speaking, as non-financial information disclosed in non-financial reports shall provide a fuller and clearer picture of company’s impact on environment and society and of company’s expected development, performance and position on the market, those information are likely to help investors or potential business partners when taking decisions on their investments or on their business cooperation, for instance. Moreover, a requirement to report on non-financial matters forces companies to manage and measure their impact on society and environment. Accordingly, thanks to mandatory non-financial reporting requirement, companies are likely to learn how to manage their

¹¹ See: <http://eur-lex.europa.eu/legal-content/EN/NIM/?uri=CELEX:32014L0095&qid=1498908547167>

¹² Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC, OJ L 182, 29.6.2013, p. 19–76

¹³ Commission Directive 2006/34/EC of 21 March 2006 amending the Annex to Directive 2001/15/EC as regards the inclusion of certain substances, OJ L 83, 22.3.2006, p. 14–15

¹⁴ Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies, OJ L 222, 14.8.1978, p. 11–31

¹⁵ Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts, Official Journal L 193 , 18/07/1983 P. 0001 - 0017

¹⁶ Directive 2014/95/EU, Recital, par. 21.

non-financial risks. Thus, according to Kinderman (2015, 1 – 2): “Directive 2014/95/EU has potentially far reaching implications: it will facilitate the comparability of information; it will help companies to identify the risk their operation pose for third parties; and it will empower stakeholders to take appropriate measures to reduce harmful risks”.

Additionally, we have to notice that the final aim of Directive 2014/95/EU is to: “increase EU companies’ long term competitiveness, and consequently, to increase EU’s long term sustainable growth”. Namely, those objectives are expressly stressed in the document called “The Europe 2020 strategy towards inclusive, smart and sustainable growth”¹⁷, and Directive 2014/95/EU is just one of numerous measures aimed to achieve objectives stressed in respective *Strategy* (see: FEE, 2016, 1).

The scope of Directive – *ratione personae*

If we want to know who does Directive 2014/95/EU apply on (or, in legal terminology, what is the *ratione personae* scope of Directive), we have to find out the meaning of the following terms: *large undertakings* and *undertakings in public interest*.

According to Directive 2013/34/EU (Art. 3/4) **large undertakings** are: „undertakings which on their balance sheet dates exceed at least two of the three following criteria:

(a) balance sheet total: EUR 20 000 000;

(b) net turnover: EUR 40 000 000;

(c) average number of employees during the financial year: 250”.

As regards Directive 2014/95/EU, it applies only on undertakings which exceed the average number of 500 employees,¹⁸ which means that condition stated under “c” must always be met. Accordingly, as regards Directive 2014/95/EU, large undertakings are those whose average number of employees during the financial year is more than 500, **and** whose balance sheet total exceeds 20 000 000 EUR **or** whose net turnover exceeds 40 000 000 EUR.

The term “**undertaking in public interest**” is also defined in Directive 2013/34 EU (see: Art. 2/2). Accordingly, undertakings in public interest are: a) listed companies - i.e. companies whose transferable securities are admitted to trading on a regulated market of any Member State; b) credit institutions; and c) insurance undertakings. Additionally, Member States are allowed to broaden this definition and to qualify as public-interest entities those undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees (for instance).

Consequently, we may conclude that Directive 2014/95/EU applies to those undertakings who **cumulatively meet following criteria: (a) large undertakings, i.e. more than 500 employees and balance sheet total over 20 000 000 EUR or net turnover over 40 000 000 EUR;** and (b) **public interest undertakings, i.e. companies listed on EU stock market / credit institutions / insurance companies / companies qualified as public interest companies under national laws.**

Nevertheless, Member States are allowed to require disclosure of non-financial information from undertakings and groups that fall outside *the ratione personae* scope of Directive 2014/95/EU, since it is only the „minimal harmonization Directive” (see: Preamble, par. 14, Directive 2014/95/EU).

¹⁷ Available at: http://ec.europa.eu/europe2020/pdf/europe_2020_explained.pdf

¹⁸ See: Directive 2014/95/EU, Art. 1(1), inserting Art 19(a) into Directive 2013/34/EU

Since the greatest number of EU member states did not broaden the *ratione personae* scope of Directive by their national laws, it is expected that approximately 6.000 large EU companies¹⁹ will be obliged to launch their first non-financial reports in year 2018.

The scope of Directive ratione materiae or what does the Directive provide

Large, public interest companies, with average number of more than 500 employees, are required to disclose a non-financial statement, included in the management report or on a separate sheet – if national law provides the possibility to issue a non-financial report on a separate sheet.

The non-financial statement shall contain information necessary to understand: (1) company's development, (2) company's performance, (3) company's position and (4) the impact of company's activities.

Aforementioned information shall relate at least to: (1) environmental matters, (2) social and employees aspects, (3) respect for human rights and (4) anti-corruption and bribery issues.

Respective information shall include: (1) a brief description of undertaking's business model, (2) a description of policies regarding CSR matters, (3) the outcome of those policies, (4) the principal risks related to CSR matters, and (5) non-financial key performance indicators relevant to the particular business (See: *Directive 2014/95/EU, Art. 1(1) inserting Art. 19(a) in Directive 2013/34/EU*).

Additionally, in Directive's 2014/95/EU Recital (par. 7 and 17) it is specified that, as regards environmental matters, non-financial information shall contain: “(...) *details of the current and foreseeable impacts of the undertaking's operations on the environment, and, as appropriate, health and safety, the use of renewable and / or non – renewable energy, greenhouse gas emissions, water use and air pollution*”.

We may conclude that, in order to comply with the mandatory requirement to report on non-financial issues, companies will have to take certain measures and actions, for instance:

- collect, measure and analyse non-financial data,
- identify, evaluate and manage risks and opportunities regarding sustainability issues,
- introduce policies, set targets and implement adequate measures,
- promote skills and incentives to drive better decision making, performance, transparency and accountability.

In order to enforce these measures and actions, it will be necessary to train employees or to engage external experts, what will anticipate additional costs for companies.

Finally, it is important to notice that a requirement to issue a non-financial statement is based on so called “*comply or explain system*”, also known as “*report or explain system*”. It actually means; „*where the undertaking does not pursue policies in relation to one or more aforementioned matters, the non-financial statement shall provide a clear and reasoned explanation for not doing so*” (see: *Directive 2014/95/EU, Art. 1(1) inserting Art. 19(a) into Directive 2013/34/EU*). Accordingly, undertakings may avoid to disclose relevant non-financial information if they explain (on clear and reasoned basis) why they have decided to do so. Nevertheless, stakeholders (investors, creditors, clients, business partners etc.) are free to estimate and evaluate such conduct (i.e. non-reporting on non-financial issues) on their own.

¹⁹ EU Commission's assessment, see: http://ec.europa.eu/finance/company-reporting/non-financial_reporting/index_en.htm#related-information-communications

How to issue a NFI?

According to original text (the draft law of Directive 2014/95/EU) a non-financial statement had to be incorporated in a management report. Unfortunately, according to final text, national states may provide by their national laws that a financial statement may be provided on separate sheet, but it must be made publicly available within a reasonable period of time, not exceeding six months after the balance sheet date, it must be disclosed on the undertaking's website, and it must be referred on into the management report (see: Art. 1(1) inserting Art. 19 (a) into Directive 2013/34/EU). It means that *integrated reporting*, which enables easy comparison with disclosed financial information, is no longer a must.

A „safe harbour” clause

According to final text (Directive 2014/95/EU) Member states are allowed to provide so called „safe harbour” clause (see Art. 1(1) inserting Art. 19 (a) into 2013/34/EU Directive). Such option was not provided according to draft text of respective Directive. It provides that certain relevant information may be omitted in exceptional cases, with the approval and under the responsibility of the management and supervisory bodies of the company, under the condition that the omission does not prevent a fair and balanced understanding of company's development, performance and its position or its impact on society. “The relevant information” means information relating to impending developments or matters in course of negotiation, and omission is justified if disclosure of such information would be seriously prejudicial to the commercial position of the undertaking.

Audit

According to Directive, the auditors are obliged only to confirm that undertakings (who Directive applies on) have provided the non-financial statement. Thus, auditors only control whether the formal condition is met, they do not control the merit of non-financial statements.

Nevertheless, member states may provide by their national laws that the non-financial statements shall be verified by an independent auditor (assurance service provider), see: Art. 1(1) inserting Art. 19 (a) into Directive 2013/34/EU.

Consolidated Non-Financial Statements

Parent companies, which are public interest companies, and who are part of the group of companies that meet same criteria as large undertakings (more than 20.000.000,00 EUR in total assets or more than 40.000.000,00 EUR in net turnover and more than 500 employees) shall include in their Consolidated Management Report a Consolidated Non-Financial Statement for group as a whole. Consequently, large public interest companies that are subsidiaries in the group of companies are exempted from the obligation to issue a Non-Financial Statement, if they are included in the Consolidated Non-Financial Statement for the group of companies, issued by the parent company (see: Art. 1(3) inserting Art. 29(a) into Directive 2013/34/EU).

3.2 Non-financial reporting and legal framework for non-financial reporting in Croatia

Directive on Non-financial Reporting has been implemented into Croatian legal system when the latest amendment of *Croatian Accounting Act* entered into force (January 1st 2017).²⁰ Croatian regulatory framework, as regards non-financial reporting, is now harmonized with Directive on Non-Financial Reporting.

Although, according to Croatian Accounting Act, mandatory non-financial reporting requirement applies only on large, public interest companies, with more than 500 employees (same criteria as

²⁰ Croatian Accounting Act, Official gazette 78/2015, 134/2015, 120/2016.

provided by Directive 2014/95/EU) we must notice that the *ratione personae* scope of Directive has been broadened according to Croatian Law. The term „public interest entities” is far broader according to *Croatian Accounting Act* (see: Art. 3/1) than according to *Non-Financial Reporting Directive*. Under the *Croatian Accounting Act* (Art. 3/1), beside *listed companies*, *credit institutions* and *(re)insurance companies* (which are public interest entities according to Directive 2014/95/EU), public interest entities are also: *financial institutions* (such as leasing companies, factoring companies, investment and hedge funds, pension funds, stock exchange markets, etc.) and *companies or other legal entities of strategic or special interest for The Republic of Croatia*. A list of strategic and special interest companies for The Republic of Croatia is compiled by the Croatian Government.

Similar definition of *public interest* entities exists in Italian national law (see: Legislative Degree No. 254, of December 30th 2016, which transpose Directive 2014/95/EU into Italian national law) where public-interest entities include: reinsurance companies, issuers of financial instruments, central depositories for financial instruments, regulated market management companies, asset management companies, open-ended invested companies, payment and electronic money institutions, financial intermediaries, real – estate brokerages etc. (see: Gottlieb, 2017, 8).

As regards *ratione materiae* scope of Directive 2014/95/EU, we may conclude that it has not been broadened by Croatian Law, as information that have to be included in non-financial statements are defined in the same way as in Directive 2014/95/EU. Accordingly, under Croatian Law, the list of information that shall be disclosed in non-financial reports is not elaborated in details, like in France or Italy (see: Gottlieb, 2017, 8 – 9).

One interesting fact

It is interesting to notice that whilst on the EU level the number of companies expected to be affected by *Non-financial Reporting Directive* failed from 18.000 to 6.000 when „public interest entities” criteria was added into the final text of Directive (*what means that of 18.000 large companies only 6.000 of them were public interest companies*), in Croatia the number of public interest companies (approximately 250) outnumbers the number of companies with more than 500 employees (approximately 200). Consequently, only 200 companies (approximately) are expected to be affected with the obligation to issue a non-financial statement for year 2017.

Provisional Provisions provided by Directive 2014/95/EU

The term “provisional provisions” stands for provisions provided by certain directive that may be provided by national laws, but there is no „a must requirement” to provide them by national laws.

Directive 2014/95/EU provides following provisional provisions:

- a) a safe harbour clause
- b) the possibility to issue a non-financial statement on a separate sheet, separated from management report
- c) the possibility to demand a merit verification of non-financial reports by an independent auditor.

As regards “safe harbour clause”, it is provided by Croatian Accounting Act, under Art. 21a / 4. The possibility to issue a non-financial statement on a separate sheet, separated from management report, is also provided by *Croatian Accounting Act*, under Art. 21a / 8. Nevertheless, according to *Croatian Accounting Act*, independent auditors only control whether non-financial statement is issued or not, what means that verification of its merit is not provided by law (see: Art. 21a / 11, *Croatian Accounting Act*), but companies may agree with an independent auditor, on contractual basis, to check the merit of their non-financial statement (see: Art. 21a / 12, *Croatian Accounting Act*).

Sanctions

Croatian Accounting Act provides penalties (fines) for undertakings who did not fulfil their obligation to report on non-financial information (Art. 42/1/23-24). The prescribed fine is between 10.000,00 and 100.000,00 HRK (approximately 1.500,00 – 15.000,00 EUR). Civil liability or criminal sanctions are not prescribed for person liable to issue a non-financial statement (i.e. for members of management and supervisory bodies or for administrators / executives who are in charge of drafting the non-financial reports). Although, civil and criminal liability of executive and non-executive directors may be invoked by applying the general rules on the liability of directors (provided by Companies Act and by Criminal Act).

3.3 National legislations across EU and Non-financial Reporting Directive

Before Directive 2014/95/EU entered into force, non-financial reporting was voluntary-based in all EU member states, except in France, UK, Denmark and Sweden (FEE, 2016, p. 3). According to some authors (for instance, see: Kinderman, 2015) there is a strong correlation between national non-financial reporting legislation and support for Non-Financial Reporting Directive adoption. Namely, of five countries that have supported the Directive (France, UK, Denmark, Belgium and Netherlands) three of them had already provided mandatory non-financial reporting for certain companies (France, UK and Denmark).

Furthermore, a member state with the strictest national legislation (as regards non-financial reporting), i.e. France, was the most prominent supporter of Non-financial Reporting Directive. Since year 2003, French Commercial Code already provides requirements set in Non-financial Reporting Directive (see: Art. L. 225 – 102-1, French Commercial Code). A list of issues that have to be covered by Non-financial Reports, according to French law, is far more detailed than according to Directive 2014/95/EU (compare: *Art. L. 225 – 102 – 1 of French Commercial Code* and *Art. 1(1) of Directive 2014/95/EU - introducing Art. 19(a) into Directive 2013/34 EU*). It has to address 42 items (or 29 items, if non-listed company issues a non-financial report), and the merit of non-financial reports has to be externally verified (see: FEE, 2016, p. 3). Additionally, in France, non-financial reporting is mandatory for all listed companies (regardless of their size) and for all joint-stock companies that have more than 500 employees and a net turnover or assets total more than 100,000,000 EUR (Art. L. 225 – 101 – 1, French Commercial Code).

On the other side, UK and Denmark had also provided mandatory non-financial reporting by their national laws, but in UK it applied only on quoted companies²¹, whilst in Denmark, reporting requirements were rather vague. Denmark introduced mandatory non-financial reporting in 2008 in annual reports for listed companies, state-owned companies and institutional investors, but companies who failed to issue a non-financial report had just to disclose that fact without explanation why they decided not to report on non-financial issues. Consequently, UK and Denmark supported the adoption of Non-Financial Reporting Directive, but they wanted to reduce its *ratione personae* and *ratione materiae* scope and to put it in line with their national laws (Kinderman, 2015, 9.)

It is interesting to notice that Denmark was the first member state that transposed Directive 2014/95/EU in its national law, on May 21st 2015, by amendment to Danish Financial Statements Acts. Accordingly, Directive 2014/95/EU is being applied in Denmark from 2016, but only on the largest listed and state-owned companies (approximately 50 companies), whilst on all large companies with more than 250 employees (approximately 1050 companies) it will be applied from 2018. Thus, what have to be included in non-financial reports is now harmonized with Directive 2014/95/EU

²¹ Quoted companies are companies whose equity share capital has been included in the Official List, officially listed in an EEA state or is admitted to dealing on NYSE or Nasdaq. See: Sec. 385 (2) Companies Act 2006.

requirements, but the scope of Directive *ratione personae* is now widened to all large companies who employ more than 250 employees (see: Hallensleben and Harrop, 2015, 12; FEE, 2016, 4).

UK has harmonized its national law with Directive 2014/95/EU in December 2016, by issuing “*Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations*”, which inserts additional sections in the UK Companies Act 2006 (Sec. 414 CA and Sec. 414 CB). The respective Regulations transpose The Directive 2014/95/EU into UK national law without broadening requirements set by Directive. Nevertheless, it is important to notice that UK now provides two similar but still different regimes for non-financial reporting. The first-one is “The Large Public-Interest Entities Regime” which applies only on entities that meets criteria set by Directive 2014/95/EU, whilst the other one is “Quoted Companies Regime” which applies on quoted companies who do not meet criteria set by Directive 2014/95/EU. The second regime remained unchanged when Regulations entered into force. Requirements provided by those two regimes are quite similar, but differences are following: *the large public-interest entities regime* provides obligation to report on anti-corruption and bribery issues and disclosure of the principal risks relating to non-financial matters and disclosure of information about companies’ risks management (see: Sec. 414 CB (2) (d)), and additionally, it requires a description of non-financial key performance indicators (see: Sec. 414 CB (1) (e)), whilst *quoted companies regime* does not provide that obligations. Instead, *quoted companies regime* provides obligation to disclose specific “community issues” (see: Sec. 414 C (7) (b) (iii)) and the obligation to disclose information on effectiveness of its non-financial policies (see: Sec. 414 C (7)), whilst *large public-interest entities regime* does not provide that obligation (see: Gottlieb, 2017, 11; Mungall, 2017).

The most prominent opponent of Non-financial Reporting Directive was Germany (reasons are already described in this paper). Nevertheless, in March 2017, Germany fulfilled its obligation to transpose Non-Financial Reporting Directive in its national law, by issuing so called “*Gesetz zur Stärkung der nichtfinanziellen Berichterstattung der Unternehmen in ihren Lage- und Konzernlageberichten*”, which will be applied from fiscal year 2017 and on. Germany did not broad neither *ratione personae* nor *ratione materiae* scope of Directive. Thus, requirements set by Directive 2014/95/EU apply on public-interested entities (listed companies, credit institutions and insurance companies) who are large (i.e. have balance sheet total of more than 20.000.000,00 EUR or net turnover of more than 40.000.000,00 EUR) and employ more than 500 employees. According to expectations (Hallensleben and Harrop, 2015, 13) new obligation will encompass about 1.000 – 1.500 companies. Non-Financial reports may be integrated in management reports or may be issued on separated sheet within the 4 months after the balance sheet date. If they are issued on separated sheet, they must be available on company’s website for 10 years. Final text of German bill which implements Directive 2014/95/EU does not provide obligation to verify the merit of non-financial report by an independent auditor, although respective verification has been provided by draft law of respective German bill.

3.4 Some conclusions as regards legal framework in Croatia

As experience in non-financial reporting within Croatian undertakings is rather limited, it will be a great challenge to meet requirements provided by Non-financial Reporting Directive and consequently by Croatian Law.

De lege ferenda solutions for Croatia:

- to prescribe mandatory merit verification of non-financial reports (like in France or in draft text of German bill that implements Directive 2014/95/EU) or to expressly prescribe that supervisory board (in two-tier system) or non-executive directors (in one-tier system) are liable for merit verification of non-financial reports

- if company has decided not to disclose relevant non-financial information, because criteria to call upon “safe harbour clause” were met, than the respective non-financial information shall be disclosed in subsequent non-financial report, when non-disclosing of information is no longer justified (see: Gottlieb, 2017, 7.)
- to expressly provide sanctions (civil liability and criminal sanctions) for liable persons in administrative, management and supervisory bodies who failed to issue mandatory non-financial reports or who are liable for providing false or incorrect information in non-financial reports. Namely, according to Croatian Accounting Act (which transposes Directive 2014/95/EU in Croatian legal system) the sanctions are provided only for undertakings, but not for directors or administrators who are in charged to draft or liable to issue a non-financial report. Although civil and criminal liability of directors may be invoked by applying the general rules on the liability of directors (provided by Companies Act and by Criminal Act) the situation would be clearer if the specific rules on directors liability for false disclosing or for non-disclosing of prescribed non-financial information were foreseen in advance.

4 Guidelines on Non-Financial Reporting

Non-financial and diversity directive required from European Commission to publish the non-binding guidelines for non-financial reporting before 6th December 2016. However, the guidelines have been published on 5th July 2017, e.i. with a delay of more than 6 months. As stated in the “Communication from the Commission on Guidelines on non-financial reporting (methodology for reporting on-financial information)” (EU, 2017) guidelines were prepared after the review of national, EU-based and international frameworks. As a result, the EU guidelines are built on different national and/or international frameworks such as: Global Reporting Initiative, Guidelines for multinational enterprises of the OECD, ISO 26000, the International Integrated Reporting Framework, UN Global Compact, etc.

The key principles of guidelines are following: (1) disclose material information, (2) fair, balanced and understandable, (3) comprehensive but concise, (4) strategic and forward-looking, (5) stakeholder oriented, (6) consistent and coherent. For each set of principles at least one example is provided and KPIs (key performance indicator) are suggested.

As for the content, in order to be in line with The Non-financial Directive, the non-financial report shall include (1) description of business model, (2) description of policies and due diligence, (3) outcomes of policies pursued, (4) information on their principal risks and their management, (5) non-financial KPIs. For each element the guidelines provide examples and KPIs. In addition, company are expected to consider following thematic aspects in their non-financial report: (1) environmental matter, (2) social and employee matter, (3) respect of human rights, (4) anti-corruption and bribery matter, (5) other (supply chain, conflict minerals). Guidelines provide sufficient set of examples and KPIs, again.

As guidelines provided by EU are non-binding, there is no obligation for companies to prepare non-financial report based on this guideless. Companies may rely on national, international, Union-based frameworks while preparing the non-financial report. Some of this frameworks are mentioned in the Directive or/and in guideline, however that list should not be considered exhaustive (EU, 2017). However, companies have to disclose information on which framework they relied on while preparing non-financial report.

5 Non-Financial Reporting in Croatia

The first reports as result of Non-financial reporting Directive implementation are expected in year 2018, addressing non-financial issues for year 2017. The current state of non-financial reporting in Croatia will be explored, taking into account that in the moment of conducting this research non-financial reports have been issued on voluntary bases.

Exploring the GRI sustainability database it can be noted that 93 non-financial reports, prepared by 21 organizations, have been disclosed (GRI sustainability database, 2017). The UN Global Compact participants search shows in totally 41 organizations from Croatia, of which 29 are either classified as companies or SMEs, i.e. profit organization. Considering only active participants (i.e. participants regularly preparing Communication on progress), it comes to 27 active profit organization (UN Global Compact participants search, 2017). Besides GRI sustainability database and UN Global Compact participants search, database prepared by Croatian business council for sustainable development has also been considered for purposes of this research. Some companies included into these databases disclosed the non-financial report issued by their foreign parent company. Since such reports have not been prepared in Croatia they are not considered for this analysis.

Number of non-financial reports issued by Croatian companies from year 2010 to year 2016 are shown in Table 1. It should be noted that the number of reports issued for year 2016 could increase since companies may issue report with time delay. Taking into consideration that the number of issued reports for year 2016 is not final, the positive trend in the number of issued non-financial reports can be noted. Therefore, it can be concluded that companies are realizing the benefits of non-financial reporting. In observed period of time, total number of issued non-financial reports is 171 issued by 42 company. In average, each company has issued 2,5 non-financial reports in six years. Focusing on Croatian publicly listed companies, Galant and Černe (2017) found that larger, more profitable and efficient companies are more probable to disclose non-financial reports.

Table 1: Number of non-financial reports issued by Croatian companies by year

	2016	2015	2014	2013	2012	2011	2010
Number of companies	22	29	27	26	24	23	20

Source: Authors compilation based on Croatian business council for sustainable development, 2017; GRI database, 2017; UN Global Compact participants search, 2017

Table 2 provides information about size of reporting companies. As evident from the table, the majority of them are large companies. Croatian large companies, although not all, will be affected by the Non-financial and diversity reporting Directive. Thus, some companies are ahead of legal requirements and they won't have a lot of problems to comply with new regulation. Reporting companies may serve as an example of good practise for other companies not yet reporting.

Table 2: Companies issuing non-financial report by size (based on financial statements for year 2015)

	Large	Middle	Small
Number of companies	28	8	6

Source: Authors compilation based on Croatian business council for sustainable development, 2017; GRI database, 2017; UN Global Compact participants search, 2017

It is also interesting to check the industry sector of the reporting companies. As evident from Table 3 the majority of reporting companies operate within manufacturing sector. The manufacturing sector

includes only 8% of all registered legal entities in Croatia, which is quite less than other sectors, like wholesale and retail trade; repair of motor vehicles and motorcycles (28%) or other service activities (15%), from which no company produced a non-financial report. (Croatian bureau of statistics, 2016) The second sector includes professional, scientific and technical activities with 7 companies.

Table 3: Companies issuing non-financial report by industry sector

Industry sector	Number of companies
Manufacturing	17
Professional, scientific and technical activities	7
Information and communication	5
Financial and insurance activities	5
Construction	3
Accommodation and F&B providers	3
Electricity, gas, steam and air conditioning supply	2

Authors compilation based on Croatian business council for sustainable development, 2017; GRI database, 2017; UN Global Compact participants search, 2017

If we bear in mind that there is approximately 250 public-interest undertakings in Croatia, but only 140 (approximately) large undertakings with more than 500 employees (not including financial institutions), we expect that about 200 companies (approximately 140 non-financial and 50 financial institutions) will be obliged to issue a non-financial statement in year 2018 for year 2017. Thus, we may conclude that the requirement to have more than 500 employees (which must be cumulatively met with other two requirements – i.e. large undertaking and public interest) significantly decreases the number of undertakings obliged to issue a non-financial reports in Croatia. Nevertheless, the number of companies that will produce the non-financial report in 2018 will increase.²²

6 Discussion and Concluding Remarks

Croatian Companies are obligated to issue annual financial reports including balance sheet, income statement and notes to financial statements. Medium and large sized companies are obligated to prepare cash flow statement and statement on changes in equity as well. Large companies and other companies obligated to prepare their financial statements in line with International Financial Reporting Standards (IFRS) also have to prepare statement of comprehensive income. Aside from annual financial reports, medium and large companies are also obligated to prepare annual management report.

Besides mentioned reporting obligation for companies operating in Croatia, starting from 2018 (and referring to the year 2017) some companies will be obligated to prepare non-financial report. As discussed previously, obligation of issuing non-financial reports refers only to the largest companies. Preparation of non-financial reports requires additional resources, so companies may expect the increase of their overall costs. Potential additional costs could be the most significant and highest in the first year of reporting.

²² For more information about non-financial reporting in Croatia and latest amendments of Croatian Accounting Act, see: Osmanagić Bedenik, 2016; Cirkveni Filipović, 2017; Vukić, 2015).

Introduction and implementation of non – financial reporting practice will consequently require improvements of employees’ knowledge about it. They can prepare themselves or participate in organized workshops and/or seminars, both requiring additional costs. Employees spending time on their own preparation won’t have time to do their everyday tasks, so maybe the new staff will be required, meaning additional costs. On the other side, participation in seminars/workshops will create costs of participation fees and travel costs. Finally, companies may hire additional person to be in charge of for non-financial reporting, which will cause direct costs for the company. However, if companies choose to hire new person with experience in preparation of non-financial reports they have to bear in mind that there is also limited number of persons with this specific knowledge. Alternative of having its own expert for non-financial reporting is in outsourcing of an external associate. In a long term it would be preferable to have its own expert, since the obligation to issue non-financial report is not a one-time deal. However, contracting an external expert is a reasonable solution for the first preparation of non-financial report. Besides costs related to the staff resources, additional costs may occur in the process of data collection. Non-financial reports preparation includes data collecting, checking and analysis of collected data, and data summarization in the form of a report. Costs associated with staff and data collection are the most significant one but not the only one, because some other costs may happen like materials needed, report design, external check, etc.

When preparing non-financial report for the first time, companies should use the benchmarking strategy. Benchmarking represents a modern management technique, which helps to identify the company’s strengths and weaknesses through comparison with best practise of competitors (Osmanagić Bedenik and Ivezić, 2006). Non-reporting companies can use non-financial reports prepared and disclosed by other companies just as a starting point and, an example of good practise. However, that does not mean that companies can plagiarize someone’s reports.

Companies may also join Global Reporting Initiative (GRI) and use their standards and guidelines for preparing non-financial reports. The G4 version of sustainability reporting guidelines is also available in Croatian language, so there is no language barrier for its implementation. In addition, GRI offers services, like seminars, workshops, etc., to help companies prepare non-financial report. According to Global Sustainability Standards Board (2017) the GRI standards can be used to comply with all the provision of the non-financial reporting Directive. For that purposes GRI has prepared the document titled “Linking the GRI Standards and the European Directive on non-financial and diversity disclosure” (available at: <https://www.globalreporting.org>) aim to help companies comply with the directive requirements using the GRI standards.

Additionally, companies may take part of UN Global Compact and prepare Communication on progress (COP). Although, COP requirements are not always sufficient to meet the Directive they may be helpful through the process (UN Global Compact, 2015). By means of online library UN Global Compact offer a wide set of free documents aiming to help companies prepare their COP, including UN Guiding principles, Reporting framework with implementation guideline, free webinar etc.

One of the aims of the paper was to analyse The Non-financial Reporting Directive in details and to evaluate whether Croatian legal framework (as regards non-financial reporting) is in line with respective Directive. Additionally, we present several legislative solutions, provided in certain EU member states, aimed to improve non-financial reporting, such as: mandatory merit verification of non-financial reports; directors’ liability for false disclosing or non-disclosing of prescribed non-financial information etc. Accordingly, we suggest those solutions as *de lege ferenda solutions* for Croatian legal system.

The aim of this paper was also to explore the reflection non-financial reporting Directive on Croatian current reporting system. The current state of non-financial reporting in Croatia was explored. Having

in mind that all non-financial reports prepared till now by the companies operating in Croatia have been prepared on voluntary basis (the first obligatory reports are expected in year 2018, referring to the year 2017), it can be concluded that non-financial reporting is not a wide established practise in Croatia. Therefore, it will be a new experience for the majority of affected companies and also a .great challenge to cope with in year 2018. The main contribution of this paper is in the presentation of current state of non-financial reporting in Croatia, as well as in presentation of the non-financial reporting directive. In addition, an attempt was made to identify the companies affected by Non-financial reporting Directive in Croatia and to give recommendations for easier adjustment to new legal framework.

Main take away of this paper is to facilitate the process of non-financial reporting for companies obligated to it. This could be done in several ways. Institutions like Croatian chamber of economy, Development agencies, Business organizations, etc. should organize seminars/workshops (potentially free of charge) in order to present the examples of good practise and/or to provide guidelines on how to prepare the non-financial report. In addition, the Directive requirements represent additional burden to company, so governments could come up with some compensation for this additional burden. For example, the compensation could be in form of taxes reduction, extension of deadlines for other obligations (like financial statements publication), etc.

Finally, although the non-financial reporting represents a great challenge for companies influenced by Non-financial reporting Directive, expected benefits for overall business should also be considered. Expected benefits could comprise: building trust, improved processes and systems, progressing vision and strategy, reduction of compliance costs, competitive advantage (GRI, n.d.) and /or reduction in cost of capital (Dhaliwal et al, 2011). In addition, non-financial reporting can provide information to the stakeholders about the future potential of the company, so that it is easier to understand company's overall performance, business strategy, and growth potential (Perrini, 2006).

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