FULL DISCLOSURE: MONTHLY BRIEFING ON EU CORPORATE TRANSPARENCY REGULATION
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Sustainability due diligence – what it means for companies and how EU sustainability standards can help

The European Commission will propose **new legislation on corporate due diligence** in autumn. In the meantime, the Corporate Sustainability Reporting Directive (CSRD) and the development of accompanying sustainability standards will play an important role in contributing to due diligence by defining related disclosure elements. Due diligence is essential to determine what the company needs to address; the CSRD will describe how the company should report it.

This article explains what human rights and environmental due diligence is, how companies can meaningfully report on it, and what issues the upcoming EU reporting standards should clarify in order to help businesses.

Introduction into due diligence

Due diligence describes the actions taken by a company to identify and act on actual and potential risks to people and to the environment. Not only within its own operations but throughout its entire supply chain. It is connected to business risk management – but starts with understanding what the risks to people and to the environment might be. It is built on proportionality – the right conduct depends on the severity of the impact, the company's involvement with the impact and its own ability to address it. Furthermore, it is guided by the principles established in international standards such as the United Nation's Guiding Principles on Business and Human Rights (UNGPs) and the OECD Guidelines for Multinational Enterprises (OECD Guidelines).

Following the OECD guidance and EU regulation for investors, banks and insurers, financial market actors are already screening their exposure to their potential involvement in infringement of land rights, access to water or deforestation in mining or agri-business projects. **Due diligence affects all companies** and can arise from everyday issues, such as harassment in the workplace or privacy of personal data. **From a reporting perspective,** companies need to be able to demonstrate that they know which risks and impacts they have or could potentially have on human rights and the environment in their value chains and that they are not contributing to any such impacts through their own actions and policies.

Good for business

The primary purpose of due diligence is to identify, prevent and mitigate negative impacts, particularly those of systemic nature. Due diligence enables companies to properly assess relevant risks and impacts that they would wish to avoid if they knew and which, if left unmanaged, would sooner or later lead to regulatory, investor, public or legal pressure.

Companies and investors are already required to assess and disclose risks to their business stemming from sustainability factors in their sustainability reporting. This cannot be done without clarity on where the company and its supply chain may have adverse impacts on people and the planet. As Eckhard Plinke[1], ESG Senior Analyst at Vontobel Asset Management, points out: "The economic value of clothing and textile companies is very closely related to the reputation of their brands, giving investors a keen financial interest in supply chain visibility and human rights due diligence."

More generally, due diligence is becoming a norm in business-to-business relationships, mainly in sectors dependent on global value chains. The ability of companies to demonstrate to their buyers that they have a sound due diligence system will become an increasingly important asset. "Investors are increasingly realising that ESG issues are intersectional. We cannot just focus on climate; we also need to look at supply chain transparency. We won't achieve the necessary climate progress without dealing with supply chains and due diligence," describes Kate Monahan[2], Director of Shareholder Advocacy at Trillium Asset Management.

The results of the 2020 Corporate Human Rights Benchmark[3] show that too many companies are still failing to meet human rights due diligence expectations and that negative impacts are mostly felt outside the company headquarters in developing countries.[4] **Out of the 229 companies assessed, 104 had at least one allegation of a serious human rights impact in 2020.**

One of the **main negative environmental impacts is deforestation**. An example of failed due diligence leading to extensive deforestation could be the case described by Global Witness, showing how the Amazon's deforestation is linked to beef global supply chains supported by EU and US banks[5].

Right response for the European Union

The legislative momentum on due diligence is high. France, Norway and Germany have recently adopted legislation that makes companies legally responsible for due diligence. The new German Supply Chain Act initiates a paradigm shift: away from purely voluntary corporate social responsibility towards binding human rights and environmental obligations for companies. It will enter into force in 2023 and will initially apply to companies with 3,000 or more employees, then from 2024 to companies with 1,000 or more employees with a registered office or branch in Germany. The new law lays down due diligence obligations that are based on the UN Guiding Principles and basically cover the entire supply chain. It also imposes certain environmental obligations on companies and introduces regulatory enforcement, according to which an authority monitors compliance with due diligence obligations and can sanction non-compliance.

This can be seen as a reaction to high-profile cases of mass harm, including the Rana Plaza textile factory fire accident, the Brumadinho dam collapse, and the increasing speed of deforestation[6] linked to agricultural

[1] ESG Investor (2021): „Due Diligance Roars Back into Fashion". https://www.esginvestor.net/due-diligence-roars-back-into-fashion/. Last retrieved: 2021-07-28.
[2] Responsible Investor (2021): „Deep-dive 8: Due diligence and supply chains in focus: can investors drive transparency and change where it's needed?". https://ri-europe-2021.responsible-investor.com/talks/deep-dive-6-due-diligence-and-supply-chains-in-focus/. Last retrieved: 2021-07-28.
[3] OHCHR (2020): „2020 Results of the Corporate Human Rights Benchmark". https://www.ohchr.org/Documents/Issues/Business/Slides.pdf. Last retrieved: 2021-07-28.
[4] Ibid.
[5] Global Witness (2021): „The supply chain linking beef to Amazon deforestation, with banks'backing". https://www.globalwitness.org/en/blog/the-supply-chain-linking-beef-to-amazon-deforestation-with-banks-backing/. Last retrieved: 2021-07-28.
[6] Esri (2018): „Deforestation in Forests arount the World". https://www.arcgis.com/apps/MapJournal/index.html?appid=e8a1cf990c524763a0b17e1b4246a10a. Last retrieved: 2021-07-28.

commodities. This has also prompted the European Commission to start preparing a proposal to harmonise the EU legal framework- with the European Parliament voting overwhelmingly in favour of this initiative[7].

Shell case: huge breakthrough for mandatory due diligence and corporate accountability

The verdict[8] handed down in May 2021 in the climate case filed by Milieudefensie[9] in 2019 against Royal Dutch Shell (Shell) has rightly been called historic: Shell must reduce its CO_2 emissions by net 45% by 2030 (compared with 2019) regardless of the actions or policies of the Dutch government. But the ruling is historic for other reasons as well: the court based its verdict to a large extent on two soft law standards – the UNGPs and OECD Guidelines. In addition, it asserts that companies have an individual responsibility to combat climate change throughout their value chains, and it very clearly links climate change to human rights. This means the judgment is likely to play an important role in the realisation of mandatory due diligence legislation.

Source: Centre for Research on Multinational Corporations (SOMO)[10]

Due diligence and sustainable finance

Human rights and environmental due diligence also plays an important role in well-advanced European and global movements towards what has been called a sustainable financial system. The EU is implementing a sustainable finance strategy to mobilise over one trillion EUR of public and private investment to support sustainable activities to meet the goals set in the EU Green Deal. The legislation specifying criteria for sustainable activities and financial products (the EU Sustainability Taxonomy and the Sustainable Finance Disclosure Regulation) require that activities and financial products marketed as sustainable must be backed by appropriate due diligence. This has been established as a needed safeguard to prevent the risks of adverse impacts being merely pushed away to supply chains. The principle of due diligence will also be reflected in the development of EU Green Bonds and Social Bonds. Today, while a majority of companies are ready to report their high-level commitments and policies, the actual due diligence process is disclosed by only 20 percent, and less than four percent provide relevant key performance indicators (KPI) on their progress. Numbers for Germany are a little better, with 25.9 percent of German companies describing their human rights due diligence process.[11]

Théo Jaekel, Corporate Responsibility Expert at telecommunications company Ericsson, is crystal clear in his support for the EU plans to introduce mandatory due diligence requirements and sustainability reporting standards. “Currently, we have the requirements to disclose certain information on due diligence, but there is no clear harmonisation on what should inform that disclosure. We see the mandatory human

[7] European Parliament (2021): „MEPs: Companies must not longer cause harm to people and plane with impunity“. https://www.europarl.europa.eu/news/en/press-room/20210304IPR99216/meps-companies-must-no-longer-cause-harm-to-people-and-planet-with-impunity. Last retrieved: 2021-07-28.
[8] De Rechtspraak (2021): https://uitspraken.rechtspraak.nl/inziendocument?id=ECLI:NL:RBDHA:2021:5339. Last retrieved: 2021-07-28.
[9] Milieudefensie (2021): „Historic victory: judge forces Shell to drastically reduce CO2 emissions“. https://en.milieudefensie.nl/. Last retrieved: 2021-07-28.
[10] SOMO (2021): „The Shell climate verdict: a major win for mandatory due diligence and corporate accountability“. https://www.somo.nl/the-shell-climate-verdict-a-major-win-for-mandatory-due-diligence-and-corporate-accountability/. Last retrieved: 2021-07-28.
[11] Alliance for Corporate Transparency (2019): „EU database 2019“. https://www.allianceforcorporatetransparency.org/database/2019.html#s_C. Last retrieved: 2021-07-28.

rights due diligence requirements to be a part of informing what companies have to report under the CSRD. The sustainability standards should clarify how companies shall report it."

Reporting of key human rights data

Results of 1000 EU companies 2019 research by Alliance for Corporate Transparency

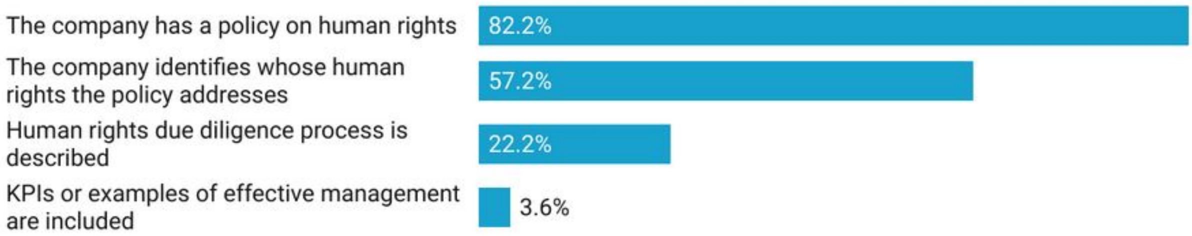

Figure 1: Research results on human rights due diligence processes among 1000 EU companies.[12]

The lack of clear standards risks greenwashing and puts companies whose business models are not intrinsically connected to systemic human rights and environmental problems at a disadvantage – in particular low-risk small and medium-sized enterprises (SMEs), as well as responsible companies that are implementing due diligence. Without clear transparency standards, it is difficult for investors, banks and insurers to distinguish between high- and low-risk companies, and as a result, they implement widely diverging approaches and indicators.

How to ensure that the Corporate Sustainability Reporting Directive provides clarity?

The increased obligations of financial actors raise the pressure on companies to disclose information on due diligence. To address the lack of clarity, the European Commission proposes in the new CSRD that a reporting standard should be developed and adopted alongside the directive on how companies should report on their due diligence, principal adverse impacts, and actions.

Such a standard should specify and clarify the following key elements of due diligence disclosures:

1. How to report on the identification and assessment of adverse impacts, taking into account that companies' exposure to such impacts varies greatly?
2. What needs to be described about the business context and relationships to the identified impact, affected people and their engagement?
3. Against what criteria do businesses need to report as to the effect their company's policies and actions have on the impacts?
4. What are the specific and sectoral KPIs that companies should assess and report on, in order to better focus, simplify and standardise information (e.g. high-risk commodities in food & beverage; working conditions in the supply chain in apparel, end-users and consumers' privacy in ICT, communities' pollution and access to water in extractives)?

[12] Ibid.

Conclusion

Although the headlines often focus on major disasters or scandals associated with a few multinational companies, all companies can unintentionally have adverse impacts on people and the planet in their value chains. Due diligence is the tool that turns the ‘unknown’ into the ‘known’ – and guides the company on what it can reasonably be expected to do about it.

Current developments in environmental and human rights due diligence in Europe and internationally are necessary to identify, mitigate, and manage risks, support fair competition, define boundaries for how far business can use ‘best efforts’ in any particular situation and to avoid negative action on the company itself from business partners or regulators.

We have highlighted how the current debate on the EU CSRD is critical to ensure the right disclosure requirements for due diligence by the company and that it must be complementary with the European Commission’s own forthcoming initiative on mandatory due diligence. We have also identified the ways in which European Sustainability Reporting Standards, accompanying the CSRD, can assist due diligence. These can be the tool helping companies to understand how they can identify potential risks and adverse impacts, which sectors might be chosen for more specific standards, and how the company’s own actions in response can be assessed and then reported.

A widely accepted framework for due diligence will enable all companies to understand and take proper responsibility for the social and environmental impacts of their business.

This article is part our series **"Full Disclosure: Monthly Briefing on EU Corporate Transparency Regulation"**, in which we aim to shed light on the need for and benefits of forward-looking reporting requirements in a changing EU regulatory environment. The series includes to date:

- **(Financial) Opportunities of European sustainability reporting rules for small businesses** (July Issue): https://germanwatch.org/en/20502
- **Climate transition plans: How EU standards can help companies to focus on the right data** (June Issue): https://germanwatch.org/de/20333
- **The EU Sustainable Finance April package and how EU sustainability reporting standards fit in** (May Issue): https://www.germanwatch.org/de/20152
- **What needs to be reported on sustainability-related governance?** (April Issue): https://germanwatch.org/en/20081
- **Reform of the EU Non-financial Reporting Directive: A Push Towards Future-proof Reporting Obligations** (March Issue): https://www.germanwatch.org/en/19990

Author: Filip Gregor, Head of Responsible Companies Section at Frank Bold
Editing: Johanna Sydow, Franziska Marten and David Ryfisch at Germanwatch

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Germanwatch e.V.

Office Bonn
Kaiserstr. 201
D-53113 Bonn
Phone +49 (0)228 / 60 492-0, Fax -19
Website: www.germanwatch.org

Office Berlin
Stresemannstr. 72
D-10963 Berlin
Phone +49 (0)30 / 2888 356-0, Fax -1
E-mail: info@germanwatch.org

This article is a part of a monthly briefings series on the latest developments on sustainability reporting.