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Boosting transparency or drowning in disclosure? Challenges and opportunities of the EU Corporate Sustainability Reporting Directive

By LAURA IOZZELLI | June 2023

Key issues

- The Corporate Sustainability Reporting Directive (CSRD) recently adopted by the European Union (EU) raises the bar with respect to sustainability reporting requirements by mandating companies to disclose detailed and comparable information. This comes at a time when greenwashing concerns about corporate 'green claims' are proliferating.
- It is unclear whether setting more stringent rules will boost corporate transparency and accountability. Greenwashing is likely to be curbed, but companies risk being submerged by disclosure requirements.
- More clarity is needed on the interoperability of the new Directive with existing international sustainability standards.
- Challenges in implementing the CSRD include difficulty to translate the double-materiality perspective into practice, high costs of harmonisation and lack of companies' capability.
- Notwithstanding the challenges, the Directive provides an opportunity to enhance corporates' transparency and strengthen mandatory sustainability reporting in Europe and possibly elsewhere.

Main features of the Corporate Sustainability Reporting Directive

Applicable since January 2023, the Corporate Sustainability Reporting Directive (CSDR) is a key component of the broader European Union sustainable finance agenda. It mandates all large, listed EU companies[4] – approximately 50,000 – as well as listed small and medium-sized enterprises (SMEs) to report on their sustainability risks, opportunities, and impacts. Companies will be required to publish detailed information on a wide range of environmental, social, and governance (ESG) issues, including climate change, biodiversity, and human rights. The information disclosed will need to specify how companies' business model and strategy align with the Paris Agreement and the EU climate neutrality goal by 2050. The Directive applies likewise to third-country companies generating a net turnover of EUR 150 million in the EU and with at least one subsidiary or branch in the EU.

The CSRD replaces Directive 2014/95/EU on the disclosure of non-financial information (NFRD)[5]. Compared to the NFRD, the CSRD sets a broader scope and introduces a more comprehensive and standardized reporting framework. It aims to address shortcomings in the existing legislation and bring more transparency for investors, consumers, and citizens. Whereas before companies had the possibility not to report on a matter if they could provide meaningful justification – the 'comply or explain' principle – the new legislation restricts this exemption, making it more difficult for companies to shy away from disclosure. Moreover, the new Directive strengthens the double-materiality principle, requiring companies to be simultaneously transparent on how sustainability matters affect their development, performance, and position, and on how their own activities impact people and the environment.[6]

Under the NFRD companies could disclose sustainability data separately from financial information. The CSRD places sustainability reporting on an equal footing as financial reporting, requiring companies to integrate sustainability information within a dedicated section of the management report. To increase credibility in the accuracy of reported data, sustainability reports will have to be certified by an accredited independent auditor consistent with European Sustainability Reporting Standards (ESRS). The latter will be adopted by the European Commission via delegated acts after technical advice from the European Financial Reporting Advisory Group (EFRAG).

The new standards will specify the kind of information to be provided by companies on, among others, their business strategy, targets (e.g., greenhouse gas emissions reduction targets), policies related to sustainability matters, actual or potential adverse effects connected with an entity's own operations and value chain, principal risks and how these are managed. By clarifying 'what' information needs to be disclosed on each sustainability issue and 'how' this should be reported, sustainability reporting standards will make it easier for companies to deal with ever-increasing demands for sustainability information. The first set of standards were delivered by EFRAG at the end of 2022 and are set to be adopted by the European Commission as delegated acts in June 2023, followed by a second set in 2024.

Challenges of the Corporate Sustainability Reporting Directive

Complexity of double-materiality

Reporting from a double-materiality perspective is problematic, not least given the intrinsic difficulty of defining what is 'material' – and therefore what information should be disclosed – on an individual company basis. Compared to single materiality, which only accounts for how sustainability factors affect the financial value of a firm, double-materiality expands the consideration of sustainability beyond an entity's capital market value, to include an entity's wider effects on society and the environment.[7] These 'effects' range from those on climate targets, transition plans, greenhouse gas emissions, employee and non-employee key performance indicators, and governance information.

Not only does double-materiality imply a larger volume of information to be reported upon, but its definition also hinges on the way a company interprets 'materiality', particularly in terms of potential negative externalities. The European Sustainability Reporting Standards require companies to report on sustainability matters which may create negative externalities, but they do not yet provide substantial clarity on how to determine what is a material, social or environmental issue. Without a clear definition of what constitutes double-materiality, the CSRD may not achieve its objectives of enhancing comparability if companies interpret reporting requirements, and most crucially, the information to be disclosed, differently.

Harmonisation of costs and lack of capability

The new Directive aims to avoid unharmonised sustainability reporting rules across Member States as fragmentation might bring about additional costs and hurdles for companies operating across borders. The goal of the Directive is to reduce reporting costs over the medium- to long-term through the adoption of a standardised reporting format, including the use of digital reporting. However, harmonisation itself will be costly, as firms within the scope of the CSRD are highly diverse as regards industry and business model and many of them operate in multiple jurisdictions or sectors. As information will have to include both forward-looking and retrospective data, major costs will be incurred by companies to create robust systems for tracking environmental, social, and governance metrics. Attention will be needed also on human capacities, technical expertise, and administrative management.

The benefits of these costs and efforts are uncertain, at least from companies' perspective.[8] Benefits are likely to become more tangible in the long-run, but the imminent, up-front costs risk distorting the cost-benefit analysis in the long-term time horizon. The phasing-in approach of the CSRD takes into account possible set-up difficulties: listed SMEs are obliged to report according to the new standards as from 2026 and can voluntarily opt-out until 2028.[9] In addition, ESRS are meant to be '*proportionate and relevant to the capacities and the characteristics of small and medium-sized undertakings and to the scale and complexity of their activities*'.[10] Accordingly, SMEs will be allowed to apply simplified standards proportionate to their capacities and resources. Simplified standards are yet to be developed and will be part of the second batch of standards to be adopted by the European Commission by 30 June 2024.[11] For the new set of standards, focusing on ways to ensure proportionality and lower the reporting burden for smaller companies will be key.

More disclosure does not equal more transparency

The sheer increase of reporting obligations does not guarantee more transparency for stakeholders.[12] More disclosure is not always or necessarily better, given that transparency can be watered down if recipients are faced with excessive or unclear information. The risk of 'information overload'[13] should also be considered, especially if some information is too specific and only relevant to a limited number of stakeholders. Disclosure will not be able to fulfil its purpose if investors find it incomprehensible and therefore ignore it. Moreover, faced with a larger quantity of information to be disclosed, companies may try to limit compliance to a minimum, as opposed to substantially change or adapt their internal procedures, with potentially negative impacts on stakeholders' evaluation. The progressive phase-in approach of the CSRD attempts to counter this risk.

Interoperability

The new legislation comes at a time of fervent international developments in corporate sustainability disclosure, including the formation of the International Sustainability Standards Board (ISSB) within the International Financial Reporting Standards (IFRS) Foundation. The CSRD acknowledges the need to avoid regulatory fragmentation and minimise disruption for undertakings that already use existing frameworks to disclose sustainability information. Accordingly, the Directive fosters convergence of European Sustainability Reporting Standards with established frameworks including, among others, the Global Reporting Initiative (GRI), the Task-Force on Climate-Related Financial Disclosure (TCFD) and the Carbon Disclosure Project (CDP), as well as any sustainability reporting standards developed under the IFRS Foundation.[14]

This is relevant particularly for non-European companies within the scope of the CSRD. Many seem to agree that while European Sustainability Reporting Standards are set to become the benchmark standards at European level, they should work in tandem with established frameworks to avoid double reporting and boost efficacy. The set of standards already adopted largely build on the key reporting pillars of TCFD and ISSB, namely governance, strategy, risk management, targets and metrics. However, while sharing similarities, these frameworks also differ, for example, around single- versus double-materiality: the ISSB relies on financial materiality, European standards hinge on double-materiality. On an operational level, it is not yet entirely clear how overlapping will be avoided and to what extent European standards will fit with other international frameworks.

Opportunities of the Corporate Sustainability Reporting Directive

More accountability for companies and clarity for stakeholders

Notwithstanding challenges, the new legislation holds the potential to provide investors, regulators, and other stakeholders with more transparent and comparable information on environmental, social, and governance risks and opportunities. Mandatory reporting coupled with a more demanding sustainability reporting environment may trigger a 'race to the top' whereby companies change substantially the way they report. European sustainability reporting standards will allow companies to better identify and manage their own risks and opportunities related to sustainability matters. Furthermore, companies will improve their reputation by enhancing dialogue with relevant stakeholders and reducing information asymmetries. The differentiation in terms of sustainability performance and disclosure will uncover leaders and laggers and may trigger a 'ranking' effect among the consumer basis, which will allow virtuous companies to distinguish themselves from greenwashing accusations.

Positive knock-on effects

For undertakings within the scope of CSRD, there are some potential internal knock-on effects that could lead to reform of long-held reporting practices. For instance, more stringent reporting rules could trigger more responsible internal decision-making mechanisms. As the CSRD gives increasing relevance to integrating sustainability factors at management level and the need to anchor sustainability in a company's corporate governance, a more proactive responsibility role will be required by administrative, management and supervisory bodies in charge of sustainability aspects. Research on the effects of the previous legislation, the NFRD, found that on average EU firms increased transparency of corporate social responsibility practices[15], suggesting optimism on the effects of the updated Directive.

More broadly, the fast-evolving EU reporting framework may be considered to build upon the adoption of the CSRD as shown, for example, by the new proposals for a 'Green Claims Directive'[16] and the Commission's 'Proposed Greenwashing Directive'.[17] The former aims to stop companies from making misleading claims about their products and services' environmental merits, while the latter aims to empower consumers for the green transition through better protection against unfair practices and better information.

A bigger role for companies in the transition to a sustainable economy

Compliance with the new rules represents a chance for companies to become more credible, trustworthy actors. By adjusting their internal procedures to the new sustainability reporting architecture, companies have the opportunity to reposition themselves in the information demand-supply spectrum, to foster investors and customers' trust, and build accountability. Given their wide impact on ecosystems and climate change, companies play a big role in the transition to a zero-carbon economy. More and better disclosure will demonstrate their leadership and make them meaningful contributors to the transition.

Potential for policy diffusion

More broadly, the CSRD is an opportunity for the European Commission to push forward its sustainable finance agenda and strengthen the evolution of mandatory sustainability reporting in Europe, matching the high ambition level of the Green Deal. If proven successful, the CSRD may not only ensure the availability of more information, but also become a case for policy diffusion in other jurisdictions. A comparison can be made with the introduction by the EU of a Carbon Border Adjustment Mechanism (CBAM).[18] Much in the same way as the establishment of a CBAM is meant to motivate foreign producers and EU importers to reduce their carbon emissions, the establishment of mandatory disclosure rules could boost the adoption of mandatory corporate disclosure rules in other jurisdictions. The far-reaching impact of the EU norms is clear considering the application of CSRD to non-EU companies operating in the EU.

Policy recommendations for developing the EU sustainability reporting framework

Clarity: In further developing and fine-tuning its standards, the EU should provide more clarity on the content of the reporting requirements, particularly as regards the definition of what is 'material' for companies and how to assess double-materiality. Further clarification will be needed also on how to ensure consistency between and integration of sustainability reporting with financial reporting.

Technical guidance/proportionality: To curb disclosure 'overload', the EU should provide companies (especially SMEs) with the necessary technical guidance on how to minimise the costs in implementing the rules and ensure that simplified reporting standards are put in place to avoid disproportionate reporting burdens.

Alignment with international frameworks: The EU should strive for progressive integration of its regulatory framework within broader international sustainability reporting initiatives to avoid duplication of and/or clash with other existing standards. Failing to do so may entail even higher costs faced by companies that will need to comply with multiple reporting requirements.

Paving the way for climate neutrality

The EU is planting the seeds for what is expected to become a comprehensive and effective corporate sustainability disclosure framework. Companies must find a way to comply with the new rules, otherwise they will incur high penalties and lose the trust of relevant stakeholders. In further shaping its sustainability reporting framework, the EU must keep in mind that transparency rules are a means, not an end. Disclosure rules are meant to serve a higher purpose, which is achieving climate neutrality by 2050. This will require making sure companies are provided with guidance and a clear, workable, and manageable sustainability reporting framework that enables them to be valuable contributors to the transition. This also suggests caution on the part of the EU in proceeding unilaterally when further developing its regulatory framework. However, it will take a few years to evaluate the effects of these promising first steps.

Endnotes

1 Here, green claims is understood as an umbrella term encompassing concepts such as 'net zero', 'carbon neutral', 'climate neutral', '100% CO2 compensated', as defined in the Proposal for a Directive of the European Parliament and of the Council on the susbtantiation and communication of explicit environmental claims (Green Claims Directive). See https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023PC0166&from=EN.

2 Carbon Markets Watch, 2023.

3 Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 december 2022 amending regulation (EU) no 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

4 Large companies under the scope of the CSRD are defined by three criteria: (1) more than 250 employees; (2) more than EUR 40 million turnover and (3) more than EUR 20 million total asset.

5 Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 on the disclosure of non-financial and diversity information.

6 CSRD, Article 1(4).

7 La Torre et al., 2020.

8 Baumüller, 2022

9 (EFRAG n/d). See https://www.efrag.org/lab6#subtitle1 (last accessed 10 May 2023).

10 CSRD, Article 29c(1).

11 ISRB, 2022.

12 Baumüller, 2022.

13 Calabrese et al., 2017.

14 See the text of the CSRD Proposal, available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX-%3A52021PC0189 (last accessed 10 May 2023).

15 Fiechter et al., 2022.

16 Proposal for a Directive of the European Parliament and of the Council on substantiation and communication of explicit environmental claims (Green Claims Directive).

17 Proposal for a Directive of the European Parliament and of the Council amending Directives 2005/29/EC and 2011/83/EU as regards empowering consumers for the green transition through better protection against unfair practices and better information.

18 Regulation (EU) 2023/956 of the European Parliament and of the Council of 10 May 2023 establishing a carbon border adjustment mechanism.

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