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The End of Greenwashing? Limits and Opportunities of the Corporate Sustainability Reporting Directive

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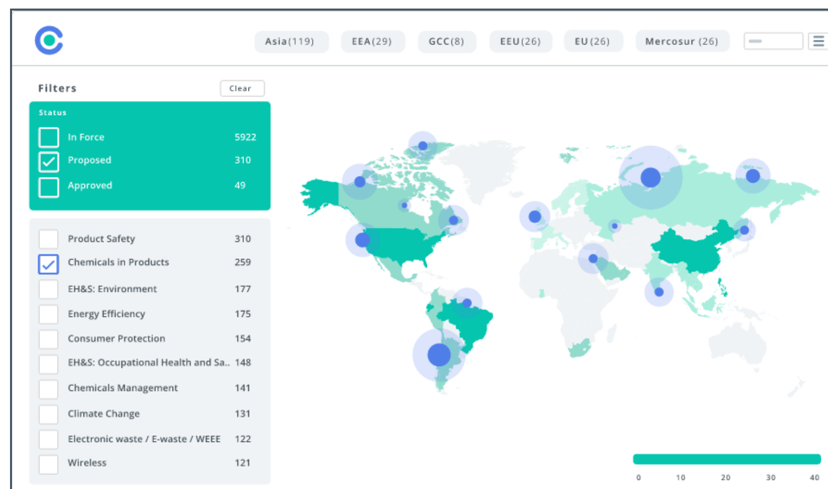

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1. Introduction

This white paper analyses the implications of the EU Corporate Sustainability Reporting Directive (CSRD) for greenwashing practices in the European Union.

Starting with an overview of greenwashing regulations in the EU, the paper highlights the limits and opportunities of the CSRD to effectively tackle greenwashing practices by exploring the concept of double materiality, the European Sustainability Reporting Standards (ESRS) and the newly established requirements for external auditing, digitalisation and external assurance.

2. What Is Greenwashing?

The adverse social and environmental impact of greenwashing practices is a persistent problem around the globe. Although there is no commonly agreed legal definition of the term as of yet, greenwashing is often referred to as a combination of two elements: a company's poor environmental performance and positive communication about the performance.

In practice, however, greenwashing is fairly complex and manifests itself in a myriad of ways. First, not all false green claims leading to greenwashing are made intentionally, since they often occur due to miscommunication within the company or the actual belief that the product or performance has a better impact on the environment than it really does. Second, green claims can be made about an individual product or about a company's general performance. Especially the latter, often referring to a company's emissions or a future net zero target, are difficult to decipher for consumers, investors and public interest groups alike.

Regulating the different forms of Greenwashing seems to have been a difficult task, but the European Commission is now leading the way with the enactment of the CSRD and the more recent proposal for a Green Claims Directive. The CSRD is described as the cornerstone of ESG reporting in the European Union. The Directive introduces more detailed reporting requirements and ensures that large companies are required to report on environmental rights, social rights, human rights and governance factors.

3. What Is ESG Reporting?

ESG reporting is increasingly perceived as a critical response to greenwashing risks. In short, ESG reporting refers to the process of disclosing information about a company's environmental, social, and governance (ESG) performance as well as its policies and practices in order to provide stakeholders with relevant and reliable information.

The purpose of ESG reporting is to ensure that organizations are accountable for their impact on the environment and society and to encourage them to adopt sustainable business practices. ESG compliance can also help organizations to manage risks, improve their reputation, and enhance their relationships with stakeholders.

4. How Will The CSRD Tackle Greenwashing Practices?

The CSRD is expected to have a direct impact on greenwashing practices by introducing mandatory reporting obligations for a broad range of companies relating to their impact on people and the environment. The CSRD modernizes its predecessor, the EU Non-Financial Reporting Directive (NFRD), by increasing the level of scrutiny of corporations.

Firstly, it substantially widens the scope of corporations subject to mandatory reporting to include large private companies, SMEs and foreign undertakings with significant EU operations. What is more, it broadens the scope of non-financial information to be disclosed to stakeholders, introduces mandatory sustainability reporting standards and establishes third-party audit assurance requirements.

Moreover, the CSRD addresses the increasing demand for sustainability information by reinforcing the concept of double materiality. Double materiality obliges companies to consider sustainability risks from an inside-out and outside-out perspective.

This concept is specific to the EU market and does not have its equivalent overseas.

Scope

In terms of scope, it is estimated that 50,000 companies will be subject to mandatory reporting, as opposed to 11,700 companies under the scope of the NFRD (EU Commission, 2021).
The reporting requirements of the CSRD apply to:

- Large public interest companies with more than 500 employees,
- Large EU companies with more than 250 employees and a EUR 40 million turnover,
- SMEs listed on regulated markets, except micro undertakings
- Large unlisted foreign companies with a net turnover of EUR 150 million in the EU and at least one subsidiary/ branch in the EU.

The mandatory reporting obligation under the CSRD will be phased in over a number of years, starting in 2024 for large public interest entities which are already subject to the NFRD and 2026 for those that are not currently subject to the NFRD.

Listed SMEs will be required to prepare for their reporting obligations from 2027 whilst third-country undertakings will become subject to the requirements from 2029.

Double Materiality

In-scope companies are required to disclose information about intangibles (social, human and environmental matters) and to provide forward looking information necessary to understand the impacts of the company on people and the environment and to assess sustainability risks faced by the company (double-materiality).
Double materiality encompasses two dimensions: impact materiality and financial materiality.

Impact materiality pertains to the undertaking's material actual or potential, positive or negative impact on people or the environment over the short-, medium- or long term.

A sustainability matter is material if it includes impacts that are directly linked to the undertaking's own operations, its products, and services through its business relationships.

A sustainability impact is material from a financial perspective if it triggers or may trigger material financial effects on the undertaking's development, including cash flows, financial position and financial performance in the short, medium and long-term. Stated differently, a matter is financially material when it becomes "investor relevant" (ESRS 1 3.3).

The result of the double materiality assessment decides whether a sustainability topic must be included in the company's report. Only those sustainability topics or information which are material from one or both of these perspectives should be included in the company's management report. The focus on double materiality will therefore oblige companies to report on metrics that are most relevant to them, thus reducing greenwashing risks resulting from information overload.

This will also ensure that investors have access to the information they need to assess not only the impact of a company on social and environmental matters but also the financial risks that a company incurs as a result of climate change or other sustainability matters.

Note that certain ESRS standards, such as [draft] ESRS E1 on Climate Change and [draft] ESRS 2 "General Disclosures", must be considered by every company irrespective of the outcomes of the materiality assessment. As such, every company falling within the scope of the CSRD is obliged to disclose climate transition plans and to report on policies and scientific targets related to climate change mitigation and adaptation (see further below).

Unfortunately, the CSRD does not bring more clarity to the question of how to apply the principle of double materiality in practice. While it goes beyond the scope of this paper to describe the process to conduct a double materiality assessment, it is worth noting that Draft ESRS 1 "General Requirements" contains a step-by-step guide on how double materiality analysis should be conducted (ESRS 1 Appendix B). The revised GRI Universal Standards 2021 also incorporate a double materiality approach which may serve the purposes of the CSRD.

Mandatory Reporting Standards

Another key component of the CSRD is the obligation to report against the mandatory European Sustainability Reporting Standard (ESRS). Until recently, reporting on ESG issues was based on the EU NFRD and was supplemented by a number of voluntary and often conflicting standards such as the standards issued by the Global Reporting Initiative (GRI), the Carbon Disclosure Project (CDP), the Sustainable Accounting Standards Board (SASB) etc. This lack of standardization resulted in reports of strongly varying quality, thereby making it very difficult for stakeholders to compare companies on the basis of their environmental and social performance.

The introduction of mandatory standards under the CSRD will facilitate comparison between companies by ensuring consistency in the way ESG information is being reported. This will be beneficial for investors who will be able to make informed decisions based on a clear set of ESG metrics.

The first set of draft mandatory standards was developed by EFRAG in November 2022. They are due to be finalized in June 2023. The 12 draft sector-agnostic include 2 cross-cutting standards, 5 environmental, 4 social and 1 governance standard. Central to these standards is the requirement for companies to report and disclose how their activities affect climate change, biodiversity, company workforce, communities and consumers.

Sector specific standards will be developed by EFRAG and submitted for a separate public consultation in the coming year. EFRAG has recently announced that their adoption will be delayed following the EU Commission’s call to prioritize support for the implementation of the first set of sector-agnostic ESRS standards.

Deep Dive: E1 Climate Change Standard

As discussed above, the European Sustainability Reporting Standards have the potential to tackle greenwashing practices effectively by standardizing the content and format of the reported information. [Draft] Standard ESRS E1 on Climate Change has been much discussed in this regard.

Reporting in accordance with this standard is mandatory for all companies, regardless of the outcome of the materiality assessment. This standard specifically requires companies to disclose Climate Transition Plans to show compatibility with transition to a sustainable economy. The transition planning requirement would require companies to demonstrate how their business model and strategy are compatible with global efforts to limit global warming to 1.5 °C. These plans must be based on measurable targets and detail how exactly the company's effort toward climate neutrality will be achieved.

As part of this process, companies must also evaluate their emissions, assess risks, define a roadmap, adapt their business strategy and track progress.

Companies must also establish and disclose their greenhouse gas emissions inventory. The inventory must cover the company's scope 1, 2 and 3 greenhouse gas emissions, taking into consideration several ISO Standards on carbon accounting and methodology. In addition to disclosing information on the actual GHG emissions, the type and amount of energy used in the company must be listed in the report.

All companies must furthermore report on the policies and actions they have taken in order to manage material impact, risks and opportunities related to climate change mitigation and adaptation. Reporting on GHG emissions at the company level must include information on existing emission reduction targets. If such targets are set, they must comply with the requirements set out in E1-4.
According to this, reduction targets must at least include target values for the year 2030 and, if available, target values for the year 2050. This also entails information on how these targets can realistically be achieved in view of the current GHG emissions inventory.

The introduction of a GHG emission inventory combined with mandatory disclosures related to emission reduction targets, funding and resources allocated to reaching those goals stand out as a positive step towards making empty promises visible to investors and NGOs.

However, as currently drafted, neither the CSRD nor the draft E1 on Climate Change formally require companies to prepare Climate Transition Plans. Instead, draft E1 requires companies to disclose Climate Transition Plans when these plans are already in place. In other words, companies can omit to disclose Climate Transition Plans if they haven't established one.

In this specific case, they must simply specify, in their report, their intention to develop such a plan and a timeline for its adoption.

This shortcoming may soon be addressed by the upcoming Corporate Sustainability Due Diligence Directive (CSDDD). The draft of the CSDDD, proposed by the European Commission in February 2022, sets out due diligence obligations for companies concerning their impacts on human rights and the environment.

On 25 April 2023, the Legal Affairs Committee of the European Parliament voted in favor of a revised CSDDD which would oblige companies with more than 1000 employees to disclose climate transition plans compatible with a global warming limit of 1.5 degree. The Committee also proposes to make directors of such large companies accountable for the preparation of these plans.

Mandatory Assurance

Perhaps most importantly, the CSRD places ESG on the same level as financial data by establishing a requirement for mandatory external assurance. Unlike the NFRD, the CSRD introduces an auditing assurance requirement to ensure that reported information is audited by qualified third parties.

The CSRD takes a proactive approach starting with limited assurance, with the aim of moving towards reasonable assurance in time.

In the short term, the CSRD requires limited assurance over compliance with the upcoming ESRS standards and the process carried out by the company to identify ESG information. Limited assurance must also be provided to check compliance with the requirement to mark-up sustainability reporting in accordance with Article 19d of the Directive (digitalisation) as well as compliance with the reporting requirements of Article 8 of the EU Green Taxonomy Regulation (Regulation (EU) 2020/852).

The requirement for reported information to be subject to "limited assurance" will then progress to a requirement for 'reasonable assurance'. In essence, reasonable assurance is where an auditor affirms that the information reported is materially correct whereas limited assurance is where the auditor affirms that it is not aware of any material modifications that should be made.

This progressive approach - from limited to reasonable assurance - was mainly motivated by the absence of commonly agreed assurance standards for ESG reporting and by the need to reduce costs for companies during the first years of implementation of the Directive. The Commission must adopt reasonable assurance standards by 1 October 2028. If the Commission adopts such standards, then the legal requirement would automatically become a requirement for reasonable assurance instead of limited assurance.

While an appropriate standard on assurance engagement has yet to be defined by the EU, the International Standard recently launched a public consultation on a proposed new standard for sustainability assurance - ISSA 5000 General Requirements for Sustainability Assurance Engagement. The consultation will open in the later part of July 2023 and extend into December 2023. When finalized, the standard will likely be a stand-alone, overarching standard suitable for both limited and reasonable assurance of sustainability information reported across any sustainability topics under multiple frameworks which may potentially include the EU CSRD.

Note that current International Standard ISAE 3000 (Revised) Assurance Engagements may also be considered as suitable to review ESG disclosures under the scope of the CSRD (CPA Ireland, 2023).

The introduction of mandatory external auditing rules will bring an unprecedented level of assurance for investors by ensuring that ESG data are accurate and reliable. This along with the obligation to prepare ESG reports in an electronically reporting format and to make them machine readable (digitalisation) will lend greater transparency and accessibility for the general public and NGOs.

Digitalisation

The CSRD requires companies to include sustainability information in a clearly identifiable section of their management reports. Reported ESG data has to be in accordance with the European Single Electronic Format Regulation. Reported sustainability information must also be tagged according to a digital categorisation system. Digitalisation will facilitate the integration of sustainability information in the European Single Access Point. The modification behind this is clear. Digitalisation aims to improve transparency and accessibility of ESG reports, thus discouraging greenwashing practices.

5. Is The CSRD A Sufficient Safeguard Against Greenwashing?

The answer is yes and no. While the CSRD is definitely a great step towards the end of greenwashing, it also has its own limitations.

Level Of Assurance Over ESG Disclosures

The first limitation relates to the level of assurance. From 2025, large companies subject to the CSRD will be legally required to include ESG data in their management reports and to ensure these reports are audited by a third-party audit on the basis of limited assurance.

The level of assurance - limited versus reasonable - essentially relates to the nature and extent of the work carried out by the auditor to check the accuracy of reported ESG data.

With no surprise, limited assurance provides a lower level of assurance and is therefore perceived as more appropriate in situations where the risk of a material misstatement is low. In limited assurance, the auditor generally limits his/her review to certain aspects of the company's report and focuses his/her audit on the process used by the company to compile ESG information. To that end, the auditor undertakes fewer test procedures and requires much less evidence to show the absence of material misstatement in the reported ESG data. The conclusions are then presented in the form of a negative opinion by stating that nothing in the process and report itself has been found to suggest that the disclosures have not been prepared in accordance with the European reporting standards.

In reasonable assurance, the auditor carries out more extensive procedures, including site investigations, and requires more evidence to check the accuracy of reported ESG information.
Reasonable assurance therefore results in a higher level of certainty and is generally perceived as more credible than limited assurance due to the higher level of evidence required from companies in the auditing process.

While nothing under the CSRD prevents larger companies from engaging in reasonable assurance audits in the short-term, the reliance on ”weaker” limited assurance during the first years of implementation of the Directive may come with inherent risks to the credibility of reported ESG information. When applied to larger and more complex entities, limited assurance may come with higher risks of material misstatement which may be perceived as a limitation of the CSRD to mitigate greenwashing risks in the coming years.

Absence Of Infringement Procedures

The CSRD is also characterized by the absence of enforcement procedures. Unlike the original proposal, the final CSRD does not stipulate sanctions or fines for non-compliance. Instead, it gives Member States a complete carte blanche to impose whatever sanctions or penalties they deem necessary in the case of infringement. Member States are nonetheless required to impose sanctions and penalties that are "“effective, proportionate and dissuasive”.

In so doing, Member States must take into account certain criteria including, but not limited to, the gravity and duration of the breach. The types of sanctions are, however, not specified under the CSRD and therefore sanctioning regimes may vary widely between Member States. This omission may result in “forum shopping” where companies may decide to establish their subsidiaries in more convenient jurisdictions.

Double Materiality: A Discretionary Process

Double materiality remains an abstract concept with inherent risks of greenwashing. While [draft] ESRS 1 (General Requirements) provide guidelines to help companies assess which sustainability information must be considered as "material" for the purposes of ESG reporting, companies will have to determine which disclosures should be included in their reports based on the results of their materiality assessment.

Draft standard ESRS 1 sets out mandatory disclosures which must always be disclosed irrespective of the results of the materiality assessment.
These include:

- [Draft] ESRS 2 General Disclosures
- The datapoints listed in [Draft] ESRS 2 Appendix C "List of datapoints in cross-cutting and [draft] topical standards that are required by EU law";
- [Draft] ESRS E1 on Climate Change (all disclosures)
- only for companies with 250 or more employees: the Disclosure ESRS S1-1 to S1-9 in [Draft] ESRS S1 Own workforce.

With the exception of the above limited information (which are mandatory irrespective of the outcomes of double materiality assessment), the disclosures specified in other topical ESRS standards may be omitted if an undertaking deems these topics to be not material according to its double materiality analysis. In this specific case, companies are only required to "briefly'' explain the conclusions of their materiality assessment (ESRS 1, para 38).

Likewise, companies are not required to disclose policies, actions and targets with respect to the sustainability matters covered in topical ESRS standards if such policies, actions and targets have not been implemented. Companies may simply disclose a timeframe in which they expect these policies, actions and targets to be in place (ESRS 1, para. 34).

This flexible approach differs from the prior draft ESRS standards (issued in April 2022) in which all disclosure requirements were presumed to be “material” for the purposes of sustainability reporting. Such a presumption was only rebuttable based on “reasonable and supportable evidence”. This meant that all topical standards were applicable unless a company could provide reasonable and supportable evidence to justify the omission of any disclosure. The “rebuttable presumption” was abandoned following the outcomes of the public consultation on the ESRS exposure drafts.

The revised [draft] ESRS standards give companies considerable leeway to omit certain metrics and targets on a discretionary basis. From there, although “double materiality” under the CSRD encourages companies to “filter in” the information to disclose only those impacts that are relevant to them, it may fall short to prevent greenwashing practices resulting from deliberate omissions.

6. Conclusion

In conclusion, the CSRD is not perfect but it is definitely a positive step towards the end of greenwashing. Central to the CSRD is the obligation of companies to report against mandatory standards and to ensure that their reports are digitally accessible and audited by a qualified third party. These innovations will have a profound impact on the way both EU companies and foreign undertakings assess and substantiate their social and environmental performance on the EU market.

ESG reporting is no longer a “nice to have '' but a “need to have”. The introduction of mandatory standards, combined with the digitalisation of ESG reports, will increase transparency and help investors compare companies more easily than before. Moreover, the broader scope of disclosure requirements will put greater pressure on companies to be more transparent about their sustainability credentials.

Ultimately this should encourage them to change their practices by creating a culture of “transparency” and an environment of “naming and shaming”.

While the CSRD introduces more comprehensive and transparent reporting requirements, the Directive lacks tangible enforcement measures and a concise approach to double materiality assessment.

As discussed above, the complex and general wording of the draft ESRS standards will likely encourage broad interpretation as to what double materiality should cover in sustainability reports.
These limitations cast serious doubt on the stated objective of the CSRD to eliminate greenwashing practices.

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