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Mandatory or Voluntary? The hybrid nature of sustainability disclosure in the EU's Corporate Sustainability Reporting Directive (CSRD)

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Abstract

Mandatory sustainability reporting has become a key policy tool in the EU's sustainable finance agenda to enhance the quality, transparency and comparability of sustainability information disclosed by companies. A notable example is the recently adopted Corporate Sustainability Reporting Directive (CSRD), which requires companies to provide investors and other stakeholders with relevant and comparable information on their sustainability performance, risks and impact based on a specific set of sustainability reporting standards. Whereas the CSRD aims to strengthen the mandatory character of the EU sustainability reporting framework, the reporting standards adopted in July 2023 by the European Commission (EC) uncover a more flexible and somewhat hybrid regulatory approach, containing both mandatory and voluntary elements. In this policy paper, we provide an overview of the evolution of the EU sustainability reporting framework and analyse the tension between mandatory and voluntary features in the reporting standards adopted by the EC. Will greater flexibility in environmental, social and governance (ESG) disclosure requirements lead to the profound environmental, economic and social changes demanded by the EU's sustainable finance agenda objectives? Or will the CSRD turn sustainability disclosure into a “cherry picking” and ‘tick-the-box’ exercise, overlooking the very essence of having a positive impact on sustainability?

Keywords

CSRD; sustainability reporting standards; voluntary disclosure; mandatory sustainability reporting; sustainable finance

Introduction

In recent years, sustainability disclosure regulations have evolved around the globe. Since the 2015 Paris Agreement, national and international policymakers have been increasingly focusing on sustainable finance, as they have been trying to embed the key principles and guidelines of international agreements in policies and new regulations. The main aims are to encourage the finance sector to adopt a more sustainable approach to decision-making and business models and to enhance transparency and reporting requirements for both financial and non-financial companies. This trend is also a response to significant pressure from various stakeholders, such as non-governmental organisations and pressure groups, to improve the environmental, social and governance (ESG) reporting practices of companies and increase accountability.

The European Union (EU) has been at the forefront of sustainable global finance strategies and has driven important initiatives to improve transparency in corporate governance mechanisms and sustainability disclosures, to channel investments towards sustainability objectives and to incorporate sustainability in risk management strategies. All this is in line with the EU Green Deal objectives to reduce greenhouse gas emissions by 55% by 2030 compared to 1990 and to reach climate neutrality by 2050, as well as with managing the risks related to climate change and with advancing towards the achievement of the sustainable development goals.

In light of this, during the current mandate of the European Commission (2019-2024) and in the context of the post-pandemic recovery, geopolitical turbulence and the EU energy crisis, the sustainable finance agenda has been given a strong impetus. One of the key pillars in this agenda consists of new sustainability disclosure rules for the financial and corporate sectors: the Sustainable Finance Disclosure Regulation (SFRD) and the Corporate Sustainability Reporting Directive (CSRD). In this policy paper we focus on the latter, and specifically on the contrast between mandatory and voluntary components of corporate sustainability disclosures in the CSRD framework.

The evolution of mandatory sustainability disclosures

The steady increase in disclosure of sustainability information can be linked to the growing interest in sustainable investments and the need to improve the comparability of information reported by companies to make them more liable (Christensen et al. 2021). Consequently, sustainability reporting has been progressively added to the traditional practice of financial reporting.

While financial reporting is required by law, disclosure of sustainability-related information has normally been a matter of company discretion. However, over the past decade many countries have started to turn to mandatory sustainability reporting, which legally binds companies to report on their social and environmental impacts. This trend has been particularly evident in the EU, for which mandatory sustainability reporting is a key policy tool to enhance the quality, accuracy, transparency and comparability of information, which is expected to contribute to climate and sustainability goals more broadly.

As mentioned above, the push for mandatory and harmonised sustainability practices is a relatively new trend in the EU, as in earlier years reporting was largely voluntary. Before disclosure became mandatory, European companies could 'cherry-pick' among the large number of national and international voluntary reporting frameworks that had been developed in response to the demand for more transparent corporate disclosure. Two notable international standard-setting organisations are the Global Reporting Initiative and the IFRS Foundation. They provide (voluntary) reporting standards/guidelines for ESG activities that aim to improve or harmonise reporting practices. EU regulatory activity on sustainability reporting has taken place in the context of such international standards and with a view to ensuring interoperability.

Against this backdrop, the 2014 Non-Financial Reporting Directive (NFRD), which covers both financial and non-financial companies, represented a major shift in EU sustainability reporting from being a voluntary to a mandatory exercise. Prior to the NFRD, non-financial information disclosure had been voluntary in almost all the EU member states and countries around the world, with companies being able to decide whether and how much to report on their social and environmental impacts (Kinderman 2020). The Directive represented a key regulatory step towards harmonisation of sustainability reporting practices in all the EU member states (La Torre et al. 2018). It aimed to enhance the consistency and comparability of non-financial information in the EU by mandating disclosure of non-financial (sustainability) information, including information on diversity, by large EU-based public-interest companies with over 500 employees, with the reporting requirements becoming effective in the 2017 financial year.

After the NFRD came into effect, other EU sustainability disclosure initiatives and regulations followed (see Table 1 for an overview of the key EU regulatory initiatives in the field). In 2019 and 2020 two important regulations were adopted: the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation. The former requires participants in financial markets and financial advisers to disclose specific information about sustainability risks and possible adverse impacts of their investments, and also to provide sustainability information on financial products. It applies at both the identity and product levels. The latter introduces a system to classify environmentally sustainable economic activities with a view to enhancing investors' confidence that the activities in which they invest contribute to environmental objectives, providing companies with incentives to make their business models more sustainable and scaling up sustainable investment.

While the adoption of the NFRD Directive put the EU on a path towards greater business transparency and accountability, several challenges soon emerged in its implementation, revealing that regulatory harmonisation is difficult due to the high adjustment costs it imposes on the private sector. Moreover, the existence of a wide variety of ESG indicators and metrics used by companies in their sustainability reporting posed a major challenge in terms of comparability and effectiveness. Despite introducing the important concept of double materiality in the regulatory framework, the Directive failed to achieve satisfactory levels of comparability, relevance and reliability of the information provided. Furthermore, the NFRD did not establish or require the use of a specific non-financial reporting standard or framework, and neither did it set detailed disclosure requirements, which left companies free to adopt any reporting standard they deemed fit. Therefore, the decision to propose a new Corporate Sustainability Reporting Directive amending the NFRD stemmed from the need to strengthen the existing legislation in the framework of the 2018 Action Plan on Financing Sustainable Growth by substantially expanding its scope of action, imposing specific reporting standards and introducing audit requirements.

Table 1. An overview of the sustainability reporting regulations adopted by the EU

Instrument	Year	Scope
Non-Financial Reporting Directive	2014	Certain large EU companies and other listed companies with 500+ employers
Taxonomy Regulation	2020	Financial market participants; all companies subject to the CSRD
Sustainable Finance Disclosure Regulation	2019	Financial market participants offering sustainable investment products and financial advisers
Corporate Sustainability Reporting Directive	2022	All large EU companies and all listed companies (except listed micro-enterprises)

Source: adapted from European Commission, 2021.

The CSRD and the European Sustainability Reporting Standards: Voluntary or mandatory?

The CSRD is a relatively new piece of EU legislation, which entered into force in January 2023 and it is part of the EU's recent policy effort to achieve its climate and environmental goals, and to promote social responsibility and good governance practices by enhancing transparency with stricter reporting requirements. Under this Directive, large companies (with more than 250 employees) are required to disclose ample information related to sustainability risks, exposures and impacts, such as issues related to climate change, biodiversity, human rights, diversity, anti-corruption and tax transparency, among others.[1]

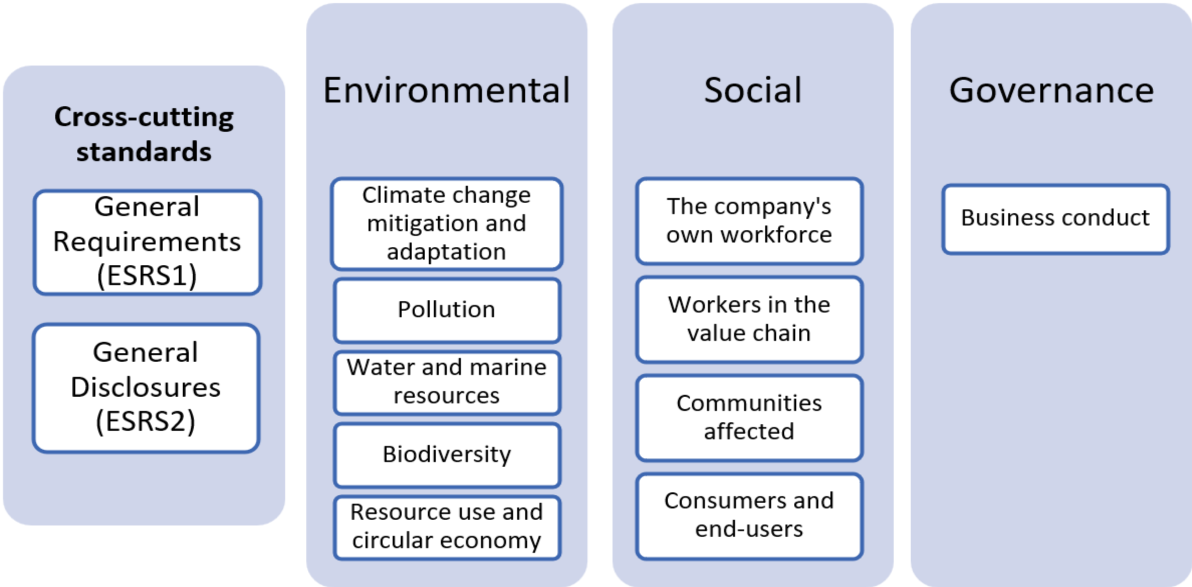
The CSRD aims to provide investors and other stakeholders with relevant, reliable and comparable information on the sustainability performance, risks and impact of companies. This will enable them to make informed decisions, to allocate capital efficiently and to hold companies accountable for their actions. It also aims to reduce reporting costs and burdens and prevent greenwashing and misleading practices. According to the Commission "by making companies more accountable for and transparent about their impact on people and the environment, this proposal can also help strengthen relations between business and society. It will also create opportunities for companies, investors, civil society and other stakeholders to radically improve the way sustainability information is reported and used thanks to digital technologies" (European Commission 2021: 8).

Importantly, the CSRD not only seeks to increase transparency for investors and to provide them with material information for decision-making but the new Directive also adopts a broad multi-stakeholder approach addressing the whole range of possible information users, including non-governmental organisations, customers, policymakers and the wider society. This comprehensive approach is reflected in the double materiality perspective of the Directive, i.e. firms are mandated to report not only on how they are affected by ESG issues but also on their own impacts on the environment and society, including externalities they cause (Christensen et al. 2021).

One of the most innovative features of the CSRD is that it requires companies to report information in accordance with specific reporting standards, the European Sustainability Reporting Standards (ESRSs), which specify the content and format of sustainability disclosures. This is a key novelty compared to the previous legislation. Whereas the NFRD aimed to achieve a certain degree of comparability and reliability of the information disclosed, the CSRD takes a step forward by establishing formal standards based on which information must be reported. The first set of ESRSs were developed by an independent technical body called the European Financial Reporting Advisory Group (EFRAG), based on existing international frameworks and initiatives. The first set of standards relate to general ESG considerations and can be categorised in four main blocks.

1 In essence, companies need to disclose how they identify, manage, and mitigate sustainability-related risks and potential impacts on their business strategies, performance, and prospects. They also have to report how they contribute to the EU's core sustainability objectives and targets.

Figure 1. The EFRAG's first set of European Sustainability Reporting Standards



Source: adapted from EFRAG 2022

As Figure 1 shows, in the first set of ESRSs drafted by the EFRAG we find cross-cutting standards applicable to all sustainability issues. These are classified as: general requirements (ESRS 1); general disclosures (ESRS 2) related to companies' general business strategies, governance and materiality assessments. The other three blocks comprise "topical standards" linked to environmental, social and governance issues that provide metrics associated with specific ESG considerations. It is not our intention to delve into the specifics of each of the standards contained in this first draft set of ESRSs, but rather to briefly focus on the general requirements for companies and to reflect on the mandatory/voluntary nature of the standards.

In short, the ESRS1 describe a set of general requirements that must be followed when companies report using the ESRSs and constitute a sort of framework for preparing the information that must be disclosed and should not be understood as specific disclosure requirements. According to the EFRAG "The undertaking shall disclose, in accordance with applicable European Sustainability Reporting Standards (ESRS), all the material information regarding impacts, risks and opportunities in relation to environmental, social and governance matters. The information shall enable the understanding of the undertaking's impacts on those matters and how they affect the undertaking's development, performance and position" (EFRAG 2022). However, as we will discuss, while the framework provides for mandatory disclosure, materiality assessment is left to the discretion of companies.

Materiality and the softening of mandatory disclosures

Compared to the NFRD, the CSRD strengthens the concept of double materiality, which according to the EFRAG "has two dimensions: impact materiality and financial materiality. A sustainability matter meets the criterion of double materiality if it is material from the impact perspective or the financial perspective or both" (EFRAG 2022: 25). The impact perspective of a sustainability matter means when it "pertains to the undertaking's material actual or potential, positive or negative impacts on people or the environment over the short-, medium- and long-term time horizons. A material sustainability matter from an impact perspective includes impacts caused or contributed to by the undertaking and impacts which are directly linked to the undertaking's operations, products and services through its business relationships" (Idem). According to the Commission, the introduction of the double materiality perspective in the ESRSs "obliges companies to report both on their impacts on people and the environment, and on how social and environmental issues create financial risks and opportunities for the company" (European Commission 2023a).

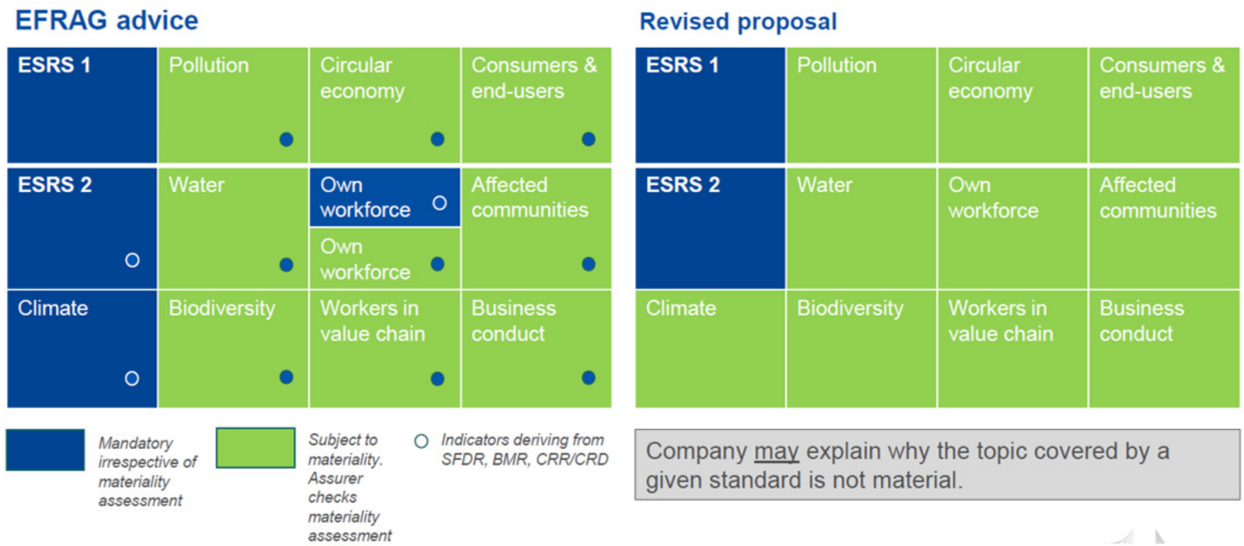
Thus, the double materiality approach is a key component of the EFRAG's overall proposed reporting framework. The information subject to the materiality assessment is intended to identify "material impacts" and risks and opportunities for the company in the short and long term. Some mandatory information needs to be disclosed independently of the materiality assessment (see Table 2). For example, under the CSRD ESRS2 are mandatory for all companies. However, as was mentioned above, the materiality assessment is carried out by the company itself. This means that companies within the scope of the CSRD can voluntarily decide which ESG topics covered by the ESRSs they consider material and therefore to be included in their sustainability reporting, and which ones they do not, as long as they provide a detailed explanation of why a topic covered by a given standard is not material to them.

After receiving the first draft of standards from the EFRAG, on 9 June 2023 the EU released the first set of draft ESRSs and subsequently opened a four-week consultation period, which closed on 7 July 2023. Reflecting the extensive feedback received from stakeholders, the European Commission introduced some important changes to the EFRAG's original proposal, particularly by making some disclosures entirely voluntary. The standards drafted by the EFRAG already contained several voluntary data points to encourage good practice ('may disclose' as opposed to 'shall disclose'). However, the Commission decided to further convert a number of mandatory data points proposed by the EFRAG into voluntary ones, including disclosure of biodiversity transition plans and specific indicators concerning "non-employees" in a company's workforce (see European Commission 2023b). Likewise, the Commission also introduced additional flexibility in disclosing the financial effects resulting from sustainability risks, engagement with stakeholders and the methodology used for the materiality assessment process. Additionally, the Commission modified data points related to corruption, bribery and the protection of whistle-blowers, ensuring they do not infringe on an individual's right to not self-incriminate.

Moreover, companies will have more flexibility to decide what is material to them. Under the revised cross-cutting standards, almost all disclosure requirements will be subject to companies' self-assessment of materiality. Importantly, disclosure requirements subject to materiality are not completely voluntary. Undertakings are legally mandated to disclose material information, and the materiality assessment process is subject to external assurance (European Commission 2023). However, companies will only be required to provide a brief explanation if they conclude that a topic is not material. Companies are also given greater leeway on topical reporting standards such as climate change-related disclosure obligations. Whereas the EFRAG proposed making all disclosure requirements and data points in the climate standard mandatory for all undertakings within the scope of the ESRSs irrespective of materiality, the Commission decided that all reporting requirements in the climate standard should be subject to a materiality assessment (see Table 2).

The annex included in the delegated act adopted by the Commission on 31 July 2023 states that the ESRSs should "specify the information that an undertaking shall disclose about its material impacts, risks and opportunities in relation to environmental, social and governance sustainability matters. ESRSs do not require undertakings to disclose any information on environmental, social and governance topics covered by the ESRSs when the undertaking has assessed the topic in question as non-material" (European Commission 2023).[2] Thus, some of the most significant changes relate to the voluntary nature of disclosure and increased flexibility. Regarding the former, the Commission argued that these changes were intended to reduce the reporting burden on companies, ensure proportionality and shift the focus to the most relevant and comparable information for stakeholders. Additionally, the Commission proposed phasing in a number of reporting metrics over a more extended period of time. In the first year of reporting, all companies will be allowed to omit information on expected financial effects related to environmental issues, such as biodiversity, pollution and water – and also certain data points related to the workforce. Furthermore, companies with fewer than 750 employees will be able to avoid disclosure of further data points in the first year.

Table 2. The European Commission's 2023 revised approach to materiality in the ESRSs



Source: European Commission "European Sustainability Reporting Standards. Presentation to the EFRAG SRB," 14 June 2023.

The difference between mandatory disclosure in the CSRD and voluntary disclosure subject to materiality assessment lies in the requirements and obligations imposed on companies regarding the reporting of ESG-related information.

Concerns have been raised regarding the potential outcomes of the revised ESRSs. It has been pointed out that the revised version could lead to fragmentation of reporting, less effective information being available to investors and a de-prioritisation of standardised reporting requirements at the expense of public interest, investors, financial institutions and society more broadly (Holmstedt Pell 2023 and Eurosif 2023). Therefore, a double challenge arises. On the one hand, the CSRD confronts companies with a stringent reporting framework that mandates them to use standardised criteria when disclosing information on sustainability issues that might create negative externalities. On the

2 *Cf.* Annex to the Commission Delegated Regulation (EU) supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards 21 July 2023. p. 2.

other hand, the Commission's approach to reporting requirements appears to leave companies with ample room for manoeuvre to choose what is relevant to report and to omit relevant information from their management reports. Simultaneously, even though the Commission has asked the EFRAG to provide guidelines on the materiality assessment procedure (see European Commission 2023b: 7), the CSRD does not yet provide guidance or clarity on how to determine what is material, or which social, environmental or governance issues should be disclosed (see Iozzelli 2023). All of this adds a further layer of complexity to our understanding of what can be considered to be fully voluntary or mandatory in the new disclosure framework.

In the next section, we further explore the voluntary-mandatory disclosure dichotomy by discussing possible trade-offs and the tension between them in the CSRD.

Trade-offs between voluntary and mandatory sustainability disclosure

In general terms, we understand voluntary disclosure as the possibility for companies to report on additional sustainability matters that are relevant to their specific context and stakeholders, beyond the minimum requirements set in the CSRD (i.e. companies will self-asses which information they deem material). This approach is rooted in legitimacy theory, according to which companies voluntarily disclose information because doing so enhances their legitimacy and public perceptions of them, in addition to being a response to expectations and demands for sustainability information from relevant stakeholders (Testarmata et al. 2019).

In the context of growing greenwashing scandals and a lack of accountability undermining the credibility of companies, disclosing relevant (material) information can be a way to increase trust among investors and other stakeholders and address the accountability gap. For many, information disclosure reduces information asymmetries among key company stakeholders such as investors, and also managers and shareholders (Hummel and Jobst 2022). In turn, lower information asymmetry decreases estimation risks and increases market liquidity (ibid.). In sum, companies usually disclose information voluntarily if the benefits of disclosure outweigh the costs.

Companies that engage in voluntary disclosure conduct a materiality assessment to identify the most significant ESG issues that affect their organisation, activities, performance and stakeholders. Materiality assessments help companies prioritise the disclosure of ESG factors that are crucial in decision-making by investors, customers, employees and other stakeholders. The benefits from carrying out materiality assessments and voluntary reporting of sustainability information include improving the reputation of companies and enhancing and raising awareness about their ESG performance and impact. However, in reality companies often lack incentives to voluntarily disclose information unless they are obliged by law (Hummel and Jobst 2022).

On the other hand, mandatory disclosure constitutes an obligation for companies to report on a set of sustainability matters that are considered essential to understand the risks, opportunities and impacts of their activities. These matters include environmental, social and employee issues, respect for human rights, anti-corruption issues and governance considerations related to sustainability. Mandatory disclosure aims to increase consistency and completeness of sustainability information and ensure that companies provide more homogeneous and comparable information that is useful for investors, regulators, consumers and other stakeholders.

Mandatory reporting can improve the reliability and comparability of reported information, with consequent reporting standardisation and reduced reporting costs. It can also have a profound influence on a company's market value. By providing investors and stakeholders with a comprehensive view of a firm's ESG performance, these disclosures create greater transparency (Hummel and Jobst 2022). Investors are increasingly recognising the value of ESG integration in their decision-making processes, and mandatory reporting empowers them with essential data to make informed choices.

Moreover, the benefits of mandatory sustainability disclosures can go beyond mere transparency. Companies subject to these regulations are compelled to take their sustainability initiatives seriously and strive for tangible improvements in their overall sustainability performance. This drive towards enhanced sustainability practices not only benefits the environment and society but also fosters more resilient and future-proof business models. Companies that embrace this ethos are better equipped to mitigate risks, identify new and attractive opportunities, and build long-term resilience in the face of evolving market dynamics and growing stakeholder demands.

While the advantages of mandatory sustainability disclosures are evident, challenges also emerge for companies as they adapt to this new landscape in the CSRD. Compliance with reporting requirements poses several difficulties for some organisations, particularly for small companies with limited resources and expertise, which may also face challenges in clearly identifying the cases in which compliance with standards is mandatory and those in which it is voluntary and subject to a materiality assessment. Regarding such companies, it appears essential for the EU to clarify and fine tune the procedures and guidelines that companies have to follow to carry out a materiality assessment.

Conclusion: The hybrid nature of disclosures in the CSRD

Analysis of the CSRD has revealed a complex and somewhat ambiguous regulatory framework concerning the voluntary and compulsory aspects of sustainability standards. While the Directive identifies certain ESRSs as mandatory for companies, it also includes others that are voluntary and subject to self-assessment. This arrangement creates a delicate balance between mandatory and voluntary elements, leading to challenges for companies, investors and supervisory authorities like the European Securities and Markets Authority (ESMA) in effectively interpreting and implementing the disclosure requirements.

The lack of clear conceptual explanations in the CSRD regarding the distinction between voluntary and mandatory standards poses difficulties for companies in determining which information must be disclosed. This ambiguity may result in inaccuracies and inconsistencies in reported data hampering evaluation of both a company’s sustainability efforts and its environmental and societal impact.

In this regard, our reading is that the CSRD introduces a hybrid approach to disclosures encompassing both mandatory and voluntary elements. It may be argued that setting mandatory disclosure rules is a form of hybrid ‘softer’ governance *per se*, since these rules do not aim to regulate corporate activities directly but instead to regulate how information on activities should be disclosed (Jackson et al. 2017). Our understanding is that the CSRD constitutes a hybrid form of governance on at least a further level, which is manifested in the Commission’s adaptability to stakeholders’ (and lobbies) concerns that ‘one size does not fit all’ and its willingness to modify EFRAG’s proposed ESRSs. This approach, while attempting to address the diverse needs of stakeholders, also introduces a certain degree of flexibility, which decreases the stringency of the standards initially developed by EFRAG and puts the new legislation somewhere in the middle between ‘mandatory’ and ‘voluntary’ in the governance spectrum. This blend of requirements, as mentioned, will undoubtedly pose substantial challenges and complexities for many actors. At the heart of the matter lies a pivotal challenge that refuses to be ignored: will this hybrid approach and greater flexibility in ESG disclosure requirements truly lead to the profound environmental, economic and social changes demanded by the key sustainability goals (SDGs)? Or will a ‘tick-the-box’ approach be encouraged, in which regulation becomes a matter of “ticking boxes” while overlooking the very essence of having a positive impact on sustainability?

Despite the existence of standards, there remains a lack of comprehensive information on how companies will integrate sustainability issues in their business models and their broader impact on the environment and society. In essence, the hybrid character of the CSRD raises fundamental questions about the clarity, consistency and effectiveness of sustainability disclosures. This points to a need for further refinement in the CSRD's approach to disclosures striking a balance between mandatory requirements and voluntary reporting to ensure meaningful and accurate sustainability reporting in the corporate sector. Achieving this balance and having greater clarity and precise guidelines on how companies must report mandatory information and perform self-materiality assessments is crucial, as the overall objective of disclosures is to make a meaningful contribution to climate change mitigation, adaptation and key sustainability goals in alignment with the EU strategy and action plan for sustainable finance and the Paris Agreement.

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