Using the European Sustainability Reporting Standards to Address Climate Change

INTRODUCTION

Implemented on January 1, 2024, the European Sustainability Reporting Standards (ESRS[1]) for climate-related financial disclosures signify a pivotal shift in integrating environmental accountability into corporate practices.[2] However, stakeholders such as the European Sustainable Investment Forum have criticized the ESRS for allowing a company not to disclose information about climate change issues if a company determines that an issue is immaterial.[3] This In Brief will examine the ESRS's role in climate change action, including the evolution of sustainability reporting and materiality assessment nuances. To mitigate the non-disclosure issue, this In Brief will argue that it is necessary to interpret the ESRS to recognize climate change issues as inherently material and subject to disclosure. Further, this In Brief will discuss ways in which the ESRS's double materiality standard offers opportunities for comprehensive materiality assessment under the U.S. Securities and Exchange Commission's (SEC) Climate Disclosure Rule.[4]

I. Background

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1. Commission Delegated Regulation (EU) 2023/2772 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards, 2023 O.J. (L __) 1 [hereinafter Commission Delegated Regulation 2023/2772]. Because, at time of writing, the Directive has not yet been assigned to a volume of the Official Journal of the European Union, this In Brief cites to the page numbers of the Directive and accompanying Annexes as they appear at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L_202302772.

2. *See* Mairead McGuinness, Eur. Comm'r for Fin. Stability, Fin. Servs. and the Cap. Mkts. Union, Speech at EFRAG annual conference, 'European corporate reporting: two pillars for success' (Nov. 28, 2023) (transcript available at https://ec.europa.eu/commission/presscorner/detail/en/speech_23_6574).

3. *See* Ian Lewis, *Final EU Sustainability Reporting Rules Trigger Fresh Wave of Criticism*, IMPACT INVESTOR (Aug. 3, 2023), https://impact-investor.com/final-eu-sustainability-reporting-rules-trigger-fresh-wave-of-criticism/.

4. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 89 Fed. Reg. 21668 (Mar. 28, 2024) (to be codified at 17 C.F.R. pts. 210, 229, 230, 232, 239, 249).

A. The Evolution of Sustainability Reporting

The evolution of sustainability reporting is rooted in addressing externalities that arise from corporate activities, notably greenhouse gas emissions and air pollution. These externalities have global effects, such as climate change and drastic weather events, with a disproportionate impact on future generations. Effectively addressing these externalities requires accurate and prompt reporting of activities that contribute to them. This involves tracking and documenting what companies consume and emit into the atmosphere, as well as understanding the broader impact of these actions on both humans and the environment.[5] For instance, accurately reporting on a company's use of fossil fuels and its contribution to global warming is crucial for addressing climate change effectively.

B. Development of the ESRS

The European Union (EU) has committed to addressing climate change and promoting sustainable development,[6] and this commitment was embodied in the European Green Deal.[7] As part of the European Green Deal, in December 2022 the EU amended its accounting standards: the Corporate Sustainability Reporting Directive (CSRD[8]).[9] The CSRD mandates certain companies to disclose in their management reports the information necessary to understand the company's impacts on sustainability matters, as well as how these matters influence the

5. *See* Patricia M. Dechow, *Understanding the Sustainability Reporting Landscape and Research Opportunities in Accounting*, 98 ACCT. REV. 481, 484-485 (Sept. 1, 2023).

6. *Communication from the Commission: Action Plan: Financing Sustainable Growth*, EUROPEAN COMMISSION (Mar. 8, 2018) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018DC0097.

7. *See generally Communication from the Commission: The European Green Deal*, COM (2019) 640 final (Dec, 11, 2019) (articulating broad policy aims to reduce European reliance on fossil fuels).

8. Directive (EU) 2022/2464 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, 2022 O.J. (L 322) 15.

9. The EU's ordinary legislative procedure enacts Regulations, Directives, and Decisions. Regulations are immediately enforceable as law across the EU. In contrast, Directives establish objectives for all member states, which then have the freedom and responsibility to enact their own laws to achieve these objectives by a set deadline. Meanwhile, Decisions are fully binding but are limited to specific groups or individuals they address. This system ensures both uniformity in goals and flexibility in execution across the diverse legal systems within the EU. *See Ordinary legislative procedure*, EUR. PARLIAMENT, https://www.europarl.europa.eu/infographic/legislative-procedure/index_en.html (last visited Nov. 25, 2024).

company.[10] In accordance with the CSRD's delegation,[11] the European Commission adopted the first set of ESRS in July 2023 to specify the content and structure that companies subject to the CSRD must disclose and use to meet the requirements under the CSRD.[12]

C. Overview of the ESRS

The ESRS outlines how companies can fulfill their reporting obligations regarding sustainability matters under the CSRD. The implementation of uniform standards is anticipated to decrease reporting expenses for companies over time by eliminating the need to comply with various voluntary standards.[13] The ESRS are structured into two overarching standards and ten specific standards. The overarching standards are General Requirements (the ESRS 1) and General Disclosures (the ESRS 2). The ESRS 1 covers the foundational principles and framework for reporting, including double materiality. The ESRS 2 outlines the necessary information for all sustainability areas, focusing on governance, strategy, risk management, and performance metrics.

The ESRS includes ten detailed standards for various sustainability topics like climate change, pollution, water resources, biodiversity, and others.[14] Each standard includes specific disclosure requirements evaluated based on their materiality. For example, the Climate Change standard concentrates on climate-related sustainability matters, aligning with the Paris Agreement goals and covering greenhouse gas emissions and related risks.[15] Under the ESRS 1, companies are

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10. The CSRD applies to publicly listed companies (including listed Small and Medium-sized Enterprises with the exception of micro-enterprises), large companies, and non-EU companies with a net turnover of EUR 150 million in the EU and with at least one subsidiary or branch in the union. Under the CSRD, a large company means one that meets two out of three of the following criteria: more than 250 employees, a turnover of over EUR 40 million, and over EUR 20 million total assets. These companies will also have to take into account information at subsidiary level. *See* Noor Crabbendam, *Corporate Sustainability Reporting Directive (CSRD) Explained*, CARBON TRUST (Dec. 15, 2022), https://www.carbontrust.com/news-and-insights/insights/corporate-sustainability-reporting-directive-csrd-explained; *Corporate Sustainability Reporting,* EUR. COMM'N (Jan. 5, 2023), https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en.

11. Once an EU law is enacted, it may require updates to accommodate developments in a specific sector or to ensure correct implementation. The European Parliament and Council have the authority to permit the Commission to adopt delegated or implementing acts. *See Implementing and delegated acts*, COUNCIL OF THE EUR. UNION https://www.consilium.europa.eu/en/council-eu/decision-making/implementing-and-delegated-acts/ (last updated Jan. 11, 2024); *see*, *e.g.*, Commission Delegated Regulation 2023/2772, 2023 O.J. (L __) 1, 1.

12. *See Questions and Answers on the Adoption of European Sustainability Reporting Standards,* EUR. COMM'N (July 31, 2023), https://ec.europa.eu/commission/presscorner/detail/en/qanda_23_4043.

13. *Id*.

14. *Id*.

15. Commission Delegated Regulation 2023/2772, 2023 O.J. (L __) 1, 73.

required to report all GHG emissions (Scope 1, 2, 3),[16] quantified as CO2 equivalents.[17]

D. Double Materiality Principle Under the ESRS

One of the ESRS's key concepts is the double materiality principle.[18] This principle mandates that a company assess the financial materiality and impact[19] materiality of sustainability matters. Double materiality merges two viewpoints: 'inside-out' (the company's impact on environmental, social, and economic factors) and 'outside-in' (the financial impact of these factors on a company).[20] If a sustainability matter meets the criteria for either impact materiality, financial materiality, or both, it is considered "material." If a company determines that the sustainability matter is material, it must disclose it.

Impact materiality deems a sustainability matter material when it does or has the potential to significantly affect "people or the environment over the short-, medium-, or long-term. . . . includ[ing] through a [company's] own operations and upstream and downstream value chain . . . its products and services, as well as through its business relationships," extending beyond direct contracts.[21]

On the other hand, financial materiality deems a sustainability matter material if it has, or is likely to have, significant financial effects on the company. This situation arises

> when a sustainability matter generates risks or opportunities that . . . could reasonably be expected to have a material influence, on the [company's] development, financial position, financial performance, cash flows, access to finance or cost of capital over the short-, medium-, or long-term. . . . originat[ing] from both historical and prospective future events.[22]

The financial materiality evaluation for risks and opportunities considers both "the likelihood of occurrence and the potential magnitude of the financial effects."[23]

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16. Scope 1 encompasses direct emissions from sources the company owns or controls. Scope 2 covers indirect emissions from energy sources like electricity, steam, or heating purchased by the company. Scope 3 is more expansive, including all other indirect emissions from activities in the company's value chain, both upstream and downstream. *Id.* at 277.

17. CO2 equivalents (CO2e) is a standard unit for measuring carbon dioxide equivalents, used to express the impact of each different greenhouse gas in terms of the amount of CO2 that would create the same amount of warming. *See What Are CO_2 Equivalents?*, MYCLIMATE, https://www.myclimate.org/en/information/faq/faq-detail/what-are-co2-equivalents / (last visited Nov. 25, 2024).

18. Commission Delegated Regulation 2023/2772, 2023 O.J. (L __) at 266.

19. Under the ESRS, impact means the effect company has or could have on the environment and people, including effects on their human rights, connected with its own operations and upstream and downstream value chain, including through its products and services, as well as through its business relationships. *See id.* at 267.

20. *See* Maria Niculescu & Alain Burlaud, *From Non-Financial Disclosure to Sustainability Reporting: New Challenges for Financial Analysts and Auditors*, 21 AUDIT FINANCIAR 685, 698 (2023).

21. Commission Delegated Regulation 2023/2772, 2023 O.J. (L __) at 10.

22. *Id*. at 11.

23. *Id*.

E. Corporate Discretion in Climate Change Reporting

While the ESRS 1 mandates that a company conduct materiality assessments for sustainability matters,[24] it allows companies discretion in reporting; they are not required to disclose information on topics deemed non-material after assessment.[25] The ESRS 1 mandates that a company "shall establish how it applies criteria, including appropriate thresholds, to determine: (a) the information it discloses on metrics for a material sustainability matter . . . and (b) the information to be disclosed as entity-specific disclosures."[26] This approach aims to provide flexibility by allowing companies to focus on relevant disclosures specific to their circumstances.[27]

More specifically, the ESRS 1 stipulates that "[i]f the undertaking concludes that climate change is not material and therefore omits all disclosure requirements in ESRS E1 Climate change, it shall disclose a detailed explanation of the conclusions of its materiality assessment with regard to climate change."[28] This implies that the ESRS permits a company not to disclose any information about climate change, provided the company offers a detailed explanation. This approach has drawn criticism for potentially enabling companies to pretend to be more environmentally friendly or sustainable than they actually are because it may allow companies to avoid disclosing certain adverse impacts by labeling them as non-material.[29] Critics, including environmental and sustainable investment organizations, argue that this could dilute the effectiveness of the ESRS, leading to less stringent reporting on critical sustainability aspects and undermining the overall goal of transparency in sustainability reporting.[30]

II. ANALYSIS

A. Mitigating Non-Disclosure by Recognizing Climate Change as Inherently Material

It is crucial to establish robust measures to prevent non-disclosure of material environmental impacts, especially those related to climate change. One way to mandate comprehensive disclosure is to interpret the ESRS in a way that acknowledges the inherent materiality of climate change issues, necessitating

24. *Id*. at 8.
25. *See id*. at 5 ("ESRS do not require undertakings to disclose any information on environmental, social and governance topics covered by ESRS when the undertaking has assessed the topic in question as non-material.").
26. *Id*. at 9.
27. EUR. COMM'N, *Questions and Answers on the Adoption of European Sustainability Reporting Standards*, *supra* note 12.
28. Commission Delegated Regulation 2023/2772, 2023 O.J. (L __) at 9.
29. *See* Lewis, *Final EU Sustainability Reporting Rules Trigger Fresh Wave of Criticism, supra* note 3.
30. *See, e*.g. NingShan Hao et al., *Effects on Corporate Stakeholders and Limitations of the Implementation of the Non-Financial Reporting Directive (2014/95/EU)*, 22 ACCT. AND MGMT. INFO. SYS. 609, 616-618 (2023).

their disclosure. In the context of general accounting, the term "material" refers to the relevance and importance of information.[31] Within the ESRS, a sustainability matter is material if it satisfies criteria for either impact materiality or financial materiality, or both.

The impact materiality assessment spans a company's entire operations and its value chain, and extends to its products, services, and business relationships.[32] Under the ESRS, it is recognized that "all global economic enterprise depends on the functioning of earth systems, such as a stable climate."[33] Companies rely on a stable climate for their operations, and their activities can directly or indirectly impact the climate by using fossil fuels (Scope 1 GHG emissions) or consuming externally purchased or acquired energy (Scope 2 GHG emissions). Their impacts can extend through the company's upstream and downstream value chain (Scope 3 GHG emissions). These impacts may be either actual, potential, or both. Therefore, it is reasonable to conclude that climate change issues must be relevant for most companies.

The ESRS defines "impact drivers" as "[a]ll the factors that cause changes in nature, anthropogenic assets, nature's contributions to people, and a good quality of life."[34] It explicitly includes "climate change" as a direct impact driver with "direct physical and behavior-affecting impacts on nature."[35] Given that global economic enterprise relies on a stable climate, corporate actions that contribute to climate change, whether directly or indirectly, are relevant to climate change. Climate change issues must therefore be important to most companies and thus should necessitate disclosure in most cases.[36]

Additionally, because ESRS 1 includes disclosures of a company's direct and indirect GHG emissions, as well as those through its value chain, it is reasonable to consider that unless the company has fully transitioned to renewable energy, its operations or parts of its value chain contribute to GHG emissions, thereby affecting climate change. Therefore, within the ESRS, these impacts on climate change could be considered inherently material for most companies, except for those that do not depend on fossil fuels and exclusively use renewable energy throughout their entire value chain.

On the other hand, the financial materiality assessment seeks to determine information critical for primary users of the company's financial reports, focusing on its potential impact on its decisions. Information is considered

31. Niculescu & Burlaud, *supra* note 20, at 698-699.
32. Commission Delegated Regulation 2023/2772, 2023 O.J. (L __) 1, 10.
33. *Id*. at 274.
34. *See id*. at 269.
35. *Id.*
36. Companies should be exempt from disclosing information about climate change only in exceptional circumstances where the issue is deemed insignificant for the company. This includes when the company demonstrates no substantial impact on climate change through its operations, upstream and downstream value chains, products, services, or business relationships. However, when companies are required to disclose climate-related information, the scope and specifics of such disclosures may vary appropriately depending on the company's unique circumstances.

material for users of general-purpose financial reports[37] "if omitting, misstating or obscuring that information could reasonably be expected to influence decisions that they make based on the [company's] sustainability statement."[38]

In this context, some might argue that climate change is only material if it has direct, substantial financial consequences for the company. However, it is noteworthy that ESRS 1 dictates that assessments of impact and financial materiality are interdependent. Thus, the issue of climate change, which may appear financially immaterial in the short term, can become financially significant over the long term as public and regulatory attention intensifies. For instance, an oil and gas company with high greenhouse gas emissions may face reduced customer loyalty and heightened legal challenges due to increasing demand for renewable energy and strengthened regulations on oil exploitation and refining; this could impact its sales and profitability. This demonstrates dynamic materiality, where environmental impacts, not initially considered financially significant, can gradually become material as they begin to influence consumer behavior and investor decisions (dynamic materiality).[39]

Although ESRS 1 permits companies to assess climate change issues as immaterial and subsequently not disclose information about climate change issues, an interpretation of the ESRS could conclude that climate change is inherently material for disclosure. As long as a company emits carbon in any part of its value chain, contributing to climate change, it could be considered to meet the threshold for impact materiality. Additionally, if carbon emissions or related events may contribute to decreased customer loyalty and potential legal challenges, affecting sales and profitability, then it meets the threshold for financial materiality.

B. Using the ESRS Double Materiality Standard to Inform the U.S. SEC's Climate Disclosure Rule

On March 4, 2024, the SEC adopted final rules to enhance and standardize climate-related disclosures for investors.[40] The ESRS could significantly influence the SEC's approach to enforcing the final rules. Notably, the CSRD and ESRS will affect U.S. companies with operations in the EU, underscoring the interconnected nature of global business and environmental regulation.[41] In this context, the ESRS could suggest ways in which the SEC understands the materiality standards and promotes comprehensive disclosure under the SEC's Climate Disclosure Rule.

37. *Id.* at 278 (defining users as "existing and potential investors, lenders and other creditors including asset managers, credit institutions, insurance undertakings").

38. *Id.* at 284.

39. Dechow, *supra* note 5, at 489-91.

40. The Enhancement and Standardization of Climate-Related Disclosures for Investors, 89 Fed. Reg. 21668 (Mar. 28, 2024) (to be codified at 17 C.F.R. pts. 210, 229, 230, 232, 239, 249).

41. *See Trends in Europe v. North America*, 40 Bus. TRAVEL NEWS no. 12, at 8 (June 12, 2023).

The ESRS and the SEC's Climate Disclosure Rule differ in several respects. The ESRS addresses a broad range of environmental, social, and governance matters issues, whereas the SEC's Climate Disclosure Rule specifically mandates material climate risk disclosures.[42] The ESRS requires Scope 3 GHG emissions disclosures related to climate change, while the SEC's rule does not.[43] In addition, the ESRS adopts the double materiality principle, considering both financial and impact materiality, whereas the SEC's rule primarily focuses on financial materiality.[44]

However, to bolster the comprehensive materiality assessment of climate-related risks under the SEC's Climate Disclosure Rule, it could be helpful for the SEC to integrate the concept of the double materiality principle of the ESRS, particularly the assessment of impact materiality and its interdependence with financial materiality.

Specifically, it is reasonable to require companies to consider both their impact on the environment and people (impact materiality) and the resulting financial risks (financial materiality) when assessing climate-related risks, particularly transition risks,[45] under the SEC's Climate Disclosure Rule. The SEC's Climate Disclosure Rule mandates that companies describe "any climate-related risks that have materially impacted or are reasonably likely to have a material impact on the registrant, including on its strategy, results of operations, or financial condition." In doing so, a company "must describe whether such risks are reasonably likely to manifest in the short-term (i.e., the next 12 months) and separately in the long-term (i.e., beyond the next 12 months) . . . [and] disclose whether the risk is a physical or transition risk."[46]

Further, under the SEC's Climate Disclosure Rule, if the risk is a transition risk, a company must disclose whether it relates to regulatory, technological, market (including changing consumer, business counterparty, and investor preferences), or other transition-related factors, and how those factors impact the company.[47] Transition risks include reduced market demand for carbon-intensive products leading to decreased prices or profits for such products, legal liability and litigation defense costs, competitive pressures associated with the

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42. *SEC Adopts Rules to Enhance and Standardize Climate-Related Disclosures for Investors*, SEC (Mar. 6, 2024), https://www.sec.gov/news/press-release/2024-31.

43. *See* Caroline A. Crenshaw, *A Risk by Any Other Name: Statement on the Enhancement and Standardization of Climate-Related Disclosures*, SEC (Mar. 6, 2024), https://www.sec.gov/news/statement/cresnshaw-statement-mandatory-climate-risk-disclosures-030624.

44. *See SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors*, SEC (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46; Gary Gensler, *Statement on Proposed Mandatory Climate Risk Disclosures*, SEC (Mar. 21, 2022), https://www.sec.gov/news/statement/gensler-climate-disclosure-20220321; Enhancement and Standardization, 89 Fed. Reg. at 21671-72.

45. "Transition risks" are risks related to a potential transition to a lower carbon economy. In contrast, "physical risks" are risks related to the physical impacts of the climate. Enhancement and Standardization, 89 Fed. Reg. at 21687.

46. 17 C.F.R. § 229.1502(a)(1) (2024).

47. 17 C.F.R. § 229.1502(a)(2) (2024).

adoption of new technologies, and reputational impacts (including those stemming from a company's customers or business counterparties).[48]

Given the interdependence of financial and impact materiality assessments, these risks might seem immaterial at first but can become financially significant over time as public and regulatory scrutiny intensifies. These regulations demonstrate how considering the concept of interdependence between impact and financial materiality, as outlined in the ESRS, could enhance comprehensive climate-related disclosures of transition risks under the SEC's Climate Disclosure Rule.

Under the SEC's Climate Disclosure Rule, a company must describe any processes it has for identifying, assessing, and managing material climate-related risks. In doing so, a company should address how it identifies whether it has incurred or is reasonably likely to incur a material physical or transition risk; decides whether to mitigate, accept, or adapt to the particular risk; and prioritizes whether to address the climate-related risk. If a company manages a material climate-related risk, it must disclose whether and how it integrated the risk into its overall risk management system or processes.[49]

This requirement underscores the relevance of the ESRS's approach, which mandates that companies assess both impact and financial materiality and disclose information that meets either or both criteria, thereby providing a more comprehensive basis for disclosure. Thus, it is reasonable to consider adopting the ESRS's approach in enforcing the SEC's Climate Disclosure Rule to more accurately assess climate-related risks and manage them more effectively, thereby providing more detailed, complete, and reliable information to investors. Integrating the interdependence of financial and impact materiality assessments under the ESRS could significantly bolster the effectiveness of a company's transition risk and its management, aligning it with the objectives of enhancing climate-related disclosures for investors under the SEC's Climate Disclosure Rule.

CONCLUSION

The ESRS signifies a pivotal advancement in combating climate change via corporate sustainability reports, highlighting the importance of integrating environmental responsibility within corporate disclosures for enhanced accuracy and transparency. Recognizing climate change as an inherently material issue for most companies is essential for reinforcing this framework's effectiveness. Furthermore, the alignment of the ESRS with global sustainability benchmarks could offer valuable insights for the SEC's Climate Disclosure Rule, particularly in conducting a thorough materiality assessment. Integrating the concept of double materiality–emphasizing interdependence between impact materiality

48. 17 C.F.R. § 229.1500 (2024).
49. 17 C.F.R. § 229.1503 (2024).

and financial materiality–in the SEC's framework could lead to a more effective approach to assessing and managing climate-related risks by companies.

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We welcome responses to this In Brief. If you are interested in submitting a response for our online journal, *Ecology Law Currents*, please contact cse.elq@law.berkeley.edu. Responses to articles may be viewed at our website, http://www.ecologylawquarterly.org.