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ESG reporting: Cabbage and turnips

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Abstract

The implementation of ESG reporting regulations is faltering. There is a regulatory chaos that is overwhelming companies and investors. The EU and the German government have created a disaster.

Zusammenfassung

Die Umsetzung von Vorschriften zur ESG-Berichterstattung stockt. Es herrscht ein Regelungschaos, das Unternehmen und Investoren überfordert. EU und Bundesregierung haben ein Desaster angerichtet.

The child had to have a name, and the European Commission's PR people called it the "Omnibus" initiative. Omnibus means "for all" and is presumably intended to signal something positive. It's about a new European Union regulation to simplify reporting obligations in the context of ESG (Environment, Social, Governance).

1. Prosperity initiative

The initiative, which was launched in November 2024, is intended to reduce regulations from the Corporate Sustainability Reporting Directive (CSRD), the Corporate Sustainability Due Diligence Directive (CSDDD), the Deforestation Regulation (EUDR), the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation. The announcement is part of the Budapest Declaration on the "New Deal for European Competitiveness". This is a twelve-point plan. The EU wants to strengthen Europe's economic prosperity, security and resilience in the coming years.

Part of the plan: "concrete proposals to reduce reporting obligations by at least 25 per cent" are to be presented in the first half of 2025. As a first step, the EU postponed the introduction of the EUDR deforestation regulation by one year, to 31 December 2025. The EUDR is intended to ensure that certain raw materials and products may only be imported, exported or made available in the EU if they are not associated with deforestation and forest degradation.

The EU is selling the postponement and reduction of reporting obligations as a growth initiative. In reality, however, both are an admission of over-regulation and regulatory chaos.

2. Regulatory chaos

This is particularly the case in Germany. This is because the CSRD Directive, the scope of which the EU wants to reduce, has not even become law in Germany yet.

The CSRD lays down strict rules on how companies must report on their efforts to reduce $CO_{(2)}$ emissions. It also requires information on social issues and corporate governance. In Germany, the German Commercial Code (HGB) serves as the legal basis into which the directive is incorporated. The latest reporting date would actually have been 6 July 2024. The CSRD would have to be applied retroactively from 1 January 2024. This means that annual reports to be prepared from 2025 onwards would have had to take the directive into account.

According to the requirements of the directive, this will be done in stages. Initially, all companies that are already subject to the Non-Financial Reporting Directive (NFRD) and therefore have to provide so-called non-financial reporting will be affected. In the EU, this includes 11,700 large companies, all of which have - presumably - prepared for the change in the directive. The CSRD adopted by the EU in January 2023 replaced the NFRD. In terms of content, the European Sustainability

Reporting Standards (ESRS), which the EU introduced on 1 January 2024, apply to the implementation of the CSRD.

It has long been clear that the CSRD conflicts with the German Supply Chain Due Diligence Act and other directives such as the CSDDD, a regulation that obliges companies to identify and mitigate environmental and social damage in supply chains, and that it is duplicated in parts. [1]

On 17 December 2024, the rump federal government wrote a letter to the EU Commission requesting that the CSRD be weakened. Among other things, unlisted corporations that are required to disclose for the previous financial year under the CSRD from 2026 onwards should not have to report until 2028. In addition, the thresholds for these companies should be raised to companies with 1,000 employees and an annual turnover of 450 million euros, in line with the CSDDD, and the number of reportable data points should be reduced.

These well-intentioned proposals, although sensible, are likely to contribute to even more uncertainty. All companies in the EU that wish to fulfil the CSRD, either mandatorily or voluntarily, are already facing as yet unknown changes this January that the "omnibus" initiative is expected to bring. In Germany, the CSRD does not yet apply, but internal and external stakeholders such as creditors or shareholders may want the information it requires or need it due to a different regulatory framework. If ESG criteria are neglected, companies may face higher interest rates on loans, for example.

However, even if German companies voluntarily apply the CSRD without a legal basis, they cannot avoid continuing the old non-financial reporting in accordance with the NFRD. This is at least the interpretation of the Institute of Public Auditors in Germany (IDW), which the auditing industry follows. This is a disadvantage compared to companies from countries such as France and Italy, where the CSRD Directive has the force of law and is therefore an individual regulation. The additional reporting also costs time and money. And it contributes to the so-called "information overload". The scope of the reports overwhelms their audience, whose awareness of potentially important information decreases.

Auditors in Germany, who have already sharpened their pencils to give their seal of approval to the implementation of the CSRD in accordance with the ESRS, have remained inactive. This is because the previous non-financial reporting (NFRD), which according to the IDW is still required of companies, is not an external (material) mandatory audit subject to , unlike the ESRS.

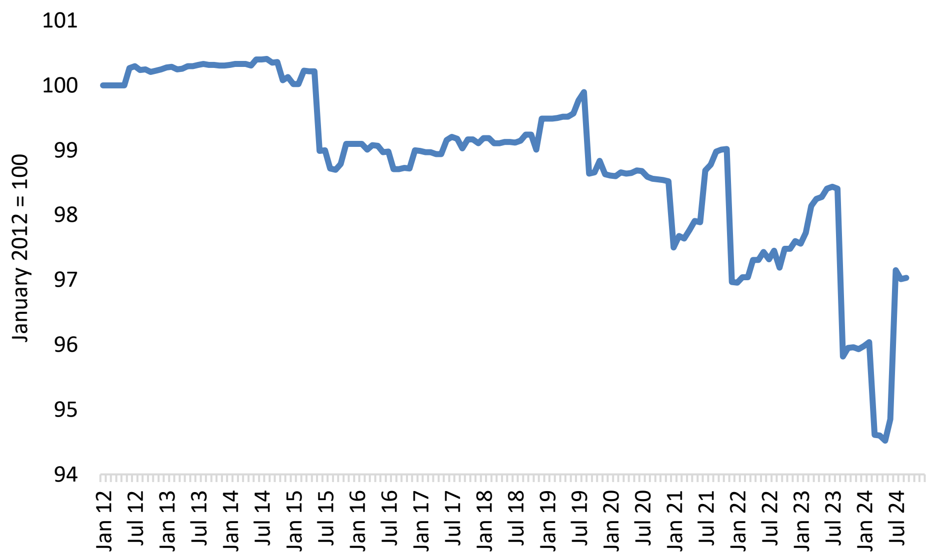
[1] The CSDDD must be transposed into German law by 25 July 2026 at the latest. The Supply Chain Due Diligence Act (LkSG) should actually be adapted to the provisions of the CSDDD during the current legislative period. According to the latest information, the Federal Office of Economics and Export Control (BAFA) is now not reviewing the existence and publication of LkSG reports until 1 January 2026.

However, as always, the devil is in the detail. In a briefing paper published on 18 December 2024, the German Accounting Standards Committee (GASC), which is responsible for accounting issues, outlined ways in which companies can link the old non-financial statement, which has not yet been abolished in Germany, with the ESRS in their annual reports. This is particularly necessary if companies have subsidiaries in an EU country in which the CSRD was implemented on time. The GASB also points out that the companies concerned have long since prepared for CSRD/ESRS and that it is hardly possible to go backwards. "A return to the previous form of reporting (non-financial statement)" is "often de facto no longer possible", according to the DRSC briefing paper. The IDW in turn published a 46-page paper "R & D on the delayed implementation of the CSRD" on 20 December, practically at the last minute.

3. Expensive rules

Whether de jure or de facto, the introduction of the CSRD is fundamentally expensive. This is illustrated by the bureaucracy cost index[2] (BKI) compiled by the Federal Statistical Office (Destatis). In July, the key month for the adoption of the CSRD, the BKI rose by 2.4 per cent compared to the previous month - and thus more sharply than ever before (Figure 1).

Figure 1: Bureaucracy cost index



Source: Destatis, Flossbach von Storch Research Institute, as at December 2024.

[2] The BKI is aimed at the effort involved in completing traditional "paperwork". This includes submitting applications, carrying out notifications, labelling, reporting statistics and providing evidence. If the German government introduces legal regulations that relieve companies of bureaucratic costs in the future, the BKI will fall. If it adopts regulations that create new bureaucratic burdens for companies, this will lead to rising CCI values.

The increase corresponds almost exactly to the annual costs of 1.58 billion euros that the federal government expects to incur if the previous CSRD is fully introduced and which the Federal Statistical Office has taken into account accordingly. Destatis itself attributes the increase in the BKI to the CSRD.

According to the Bundestag, the annual bureaucracy costs for the economy amounted to around 67 billion euros in 2024 (as at 31 March). Germany would lose up to 146 billion euros per year in economic output due to bureaucracy. This is the estimate of a recent study conducted by the ifo Institute on behalf of the Chamber of Industry and Commerce for Munich and Upper Bavaria.

Costs are also incurred in the financial and corporate sector for ratings. Despite the hullabaloo surrounding ESG reporting and the now unknown changes associated with it as part of the Omnibus Initiative, the Council of the EU adopted a regulation on ESG rating activities on 19 November 2024. The new rules aim to make rating activities in the EU more consistent, transparent and comparable in order to "strengthen investor confidence in sustainable financial products". However, the question of whether companies will even be able to provide consistent and relevant data for transparent and comparable ESG ratings on a mass scale is being raised more than ever with the postponement, dilution and different speeds for the introduction of rules.

4. Legal uncertainty

The CSRD has not been introduced in Germany as required by the EU - which has now resulted in infringement proceedings against Germany. However, it is questionable whether the federal government could evade the CSRD altogether. This is because compliance with the principle of subsidiarity within the EU can only be reviewed retrospectively (after the legislative act has been adopted) by means of an action before the Court of Justice of the European Union. Subsidiarity means that the EU may only adopt regulations in areas that cannot be better regulated at regional or EU member state level.

For the time being, the EU's admission and the rump federal government's realisation that it has long over-regulated the ESG is likely to be all that remains. However, the complex regulations are likely to remain in place in principle.

So now Brussels is tinkering with regulations that will apply just a few days into the new year 2025. But not everywhere - in Poland and Spain, for example, the CSRD has not yet come into force. Other rules relating to climate and the environment have either been postponed or are also to be reduced in the ongoing process. The damage is great. There is legal uncertainty. Personnel capacities that have been built up for processing the rules may no longer be fit for purpose. In addition, the EU's eternal dream of creating European rules as a blueprint for a global standard is likely to be over once again, at the latest in view of the current chaos.

Meanwhile, in Frankfurt, the International Sustainability Standards Board (ISSB) is relentlessly pushing ahead with the IFRS Sustainability Disclosure Standards (IFRS SDS). These accounting rules, which are also mandatory for companies, are supposedly closely coordinated with the ESRS, which either do not yet apply or are most likely to be slimmed down. The EU is also having its say on IFRS SDS through its EFRAG committee[3] . For example, there is a joint statement on "climate accounting". EFRAG, in turn, has already written 162 explanatory notes on the ESRS, which are intended to provide assistance for companies and auditors that have presumably long been overburdened

And for small and medium-sized, non-capital-market-oriented companies, there has been a voluntary standard for sustainability reporting (VSME) since mid-December 2024. Voluntary means that the standard (unlike the CSRD) is not transposed into national law via an EU regulation. However, SMEs will also have to provide it involuntarily, for better or worse, if banks, for example, demand sustainability information as part of the EU taxonomy for lending (green asset ratio).

So if there is anything that is not entirely clear to you in connection with ESG, CSRD, CSDDD, EUDR, ESRS, IFRS SDS, SFDR, VSME or the entire EU taxonomy, you should take comfort in the fact that you are almost certainly in the majority. This is probably one of the reasons why the DSRC will be holding a public, virtual event on 8 January 2025 to provide information on how to navigate the ESG jungle.

Time is of the essence, as reporting obligations are notoriously subject to strict deadlines. The only thing that is certain is that the result will be an incomparable cabbage and turnip report with questionable test results.

[3] EFRAG originally stood for European Financial Reporting Advisory Group. Today, the body only uses the abbreviation for its name.

LEGAL INFORMATION

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