July 2023

To:

Ms. Ursula von der Leyen, President of the European Commission

Ms. Mairead McGuinness, Commissioner for Financial services, financial stability and Capital Markets Union European Commission Rue de la Loi 200 1049 Brussels Belgium

Mr. Valdis Dombrovskis, Executive Vice-President for an Economy that works for People

Mr. Frans Timmermans, Executive Vice-President for the European Green Deal

Mr. Didier Reynders, Commissioner for Justice

European Commission
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cc:

Mr. John Berrigan, Director-General, DG FISMA

Ms. Florika Fink-Hooijer, Director-General, DG ENV

Mr. Kurt Vandenberghe, Director-General, DG CLIMA

Ms. Kerstin Jorna, Director-General, DG GROW

Mr. Koen Doens, Director-General, DG INTPA

Subject: Academic Community Deeply Concerned About Scientific Basis of the European Commission's Draft Delegated Act of ESRS Set 1.

Dear President von der Leyen,
Dear Executive Vice-Presidents and Commissioners,

First of all, **we - 18 academics from 12 universities -** would like to commend the fact that the Commission decided to pursue the idea of setting the standards through a multi-stakeholder process. The Commission invited experts to a three-year process to provide evidence-based input to shape the Corporate Sustainability Reporting Directive (CSRD). We are also glad to see that the Commission decided against a climate-first approach.

However, we feel deeply concerned about the changes to the European Sustainability Reporting Standards (ESRS) Set 1 at the eleventh hour. We want to strongly encourage you to reintroduce the scientific backbone in the ESRS Set 1. The Commission proposed the CSRD as an improvement and successor to the Non-Financial Reporting Directive (NFRD), but with the proposed last-minute changes, the CSRD will repeat the exact same mistakes as its predecessor. The changes also lack any scientific justification.

1. The changes in the Draft Delegated Act compromise the effectiveness of the CSRD

The scientific community looked at and evaluated the NFRD's effects on disclosure quality after it entered into force. Research characterised the NFRD as providing a high level of flexibility to entities and as a result, the quality of disclosure did not improve.[1] The NFRD was a result of mandatory and voluntary elements, considering that the NFRD represented a binding requirement with non-binding guidelines.[2] In the literature, the NFRD is not considered to be too strict, because EU Member States, and consequently entities, were given a lot of discretion for action.[3] This flexibility allowed companies to "cherry-pick" the sustainability topics they reported on. Currently, with the development of the CSRD and with the Commission watering down ESRS requirements, it is easy to draw an analogy with the NFRD and to be sceptical and worried about its effectiveness and its incremental improvement over the NFRD.

The experts involved in drafting the ESRS drew lessons from these shortcomings of the NFRD and set out to create a set of evidence-based recommendations for the Commission to turn into a Delegated Act (DA). **However, in the proposed DA, the Commission made changes that affect the core principles of effective disclosure** and thus fall short of its stated goal that the CSRD "modernises and strengthens the rules concerning the social and environmental information companies have to report".[4] Therefore, **we would like to draw the Commission's attention to the scientific evidence that clearly highlights situations when a disclosure mandate will not achieve its intended results.**

2. The changes in the Draft Delegated Act made to the ESRS Set 1 lack scientific justification.

The attempt to reduce the reporting burden is laudable. The three main changes are: (1) make all sustainability topics and data points subject to materiality assessment, (2) eliminate some data points from disclosure mandates, (3) lower reporting requirements during a phase-in period. However, to the best of our knowledge, there seems to be no scientific evidence yet that these changes can actually achieve this.

As we explain in more detail in the Annex, it is not clear that the increased role of the materiality assessment will lead to lower preparation costs. The Commission provides no evidence on how the changes applied to EFRAG's draft lower the reporting burden for companies and why the specific changes are the most effective ones in this regard. This is an especially noteworthy critique because the move to make all sustainability topics and data points subject to the materiality assessments increases the role of the materiality assessment and could potentially even increase costs. At the same time, when all sustainability topics and data points are subject to the materiality assessment, the benefits of sustainability disclosure are decreased, especially due to lower comparability and lower credibility.

Conclusion

We are disappointed that the decisions taken seem to be political, not scientific. The recommendations by EFRAG were largely based on evidence. Without that foundation, the CSRD will not "strengthen the rules concerning the social and environmental information companies have to report". We cannot be arbitrary with science. If there is scientific evidence on fundamental steps necessary for effective disclosure, there is no room for interpretation on the actions decision-makers have to take. Any changes that are political but not based on science, will fundamentally erode the effectiveness of this much-needed Directive.

[1] Korca et al. (2021) (link); Venturelli et al. (2020) (link)
[2] Korca and Costa, (2021) (link)
[3] Aureli et al., (2019) (link)
[4] European Commission, (2023) Corporate sustainability reporting (link)

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Yours sincerely,

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Annex to the letter

1. Fundamental changes undermine the materiality logic

In the Draft Delegated Act, the Commission argues: "*Materiality: all standards and all disclosure requirements and data points within each standard will be subject to materiality assessment by the undertaking, with the exception of the disclosure requirements specified in the "General disclosures" standard. This measure is expected to lead to a significant burden reduction for undertakings and helps to ensure that the standards are proportionate*" (p. 5-6), but there is no scientific evidence provided by the Commission to support that expectation.

a. Materiality assessments in the realm of sustainability reporting can be expected to be extensive and burdensome for companies, because the process is characterised by complexity, uncertainty and a high degree of evaluative nature.[5] Therefore, it is unclear why the Commission expects a "significant burden reduction for undertakings" when it makes all standards, all disclosure requirement and all data points subject to a materiality assessment. Alternatively, a set of mandatory indicators could reduce the reporting burden, allow companies to focus on addressing impacts and risks, and alleviate the burden on auditors.
b. There are conflicting views of what is material, even within sector and entities of the same size and a unified understanding is difficult to achieve.[6] Therefore, even within the same industry sector, different companies will very likely disclose information about different sustainability topics. If the data points within each standard will be subject to materiality, this will significantly hamper the creation of comparability,[7] which is among the main objectives of the CSRD.
c. The decrease in comparability is not the only potential benefit inhibited by new materiality assessment approach. There is a high likelihood that the large degree of discretion inherent to the materiality assessment will inhibit the credibility of sustainability disclosures. Investors cannot rule out that companies use materiality assessments for cherry picking, impression management and even greenwashing by emphasising mainly sustainability topics for which the reporting entity can show good performance on some topics while going dark on others. The potential decrease in comparability and credibility in combination with the rather unclear burden reduction can negatively affect the cost-benefit relation of sustainability disclosure.

2. Mandatory indicators for effective regulation

Additionally, the Commission writes "*It has committed to rationalise reporting obligations, while maintaining the ambitious objectives of its legislation. While certain reporting obligations are essential, they need to be as efficient as possible, avoiding overlaps, removing unnecessary burdens and using as much as possible digital and interoperable solutions" (p. 5)*.

a. Mandatory reporting is a key building block for ambitious and effective disclosure legislation, crucial to maintain the ambitious objectives of the legislation, while contributing to the efficiency and interoperability. Academic literature has found that disclosure mandates can lead to

[5] Garst, Mass, Suijs, (2022) (link)
[6] Puriola and Mäkelä (2019) (link)
[7] Korca et al. (2023) (link)

improvements in sustainability performance or what is known as "real effects" of disclosure regulation. These improvements have been shown for general disclosure requirements[8] as well as for specific disclosures on carbon emissions[9] or mine accidents.[10] At the same time, academic literature shows positive effects on the information environment stemming from mandatory sustainability reporting, amongst others on lower information asymmetry,[11] analyst forecast accuracy,[12] and cost of equity.[13]

b. The Commission is proposing to change from what initially was planned to be a mandatory requirement to becoming voluntary, highly discretionary, or part of a phase-in process. This action is taken under the argumentation that it is rational to ease some reporting obligations. One of the disclosure topics that is now voluntary is biodiversity and transition plans. The World Economic Forum characterised biodiversity loss as the 3rd most severe economic risk that humanity will face over the next decade.[14] Therefore, disclosure on biodiversity issues are *highly* relevant to capital market participants to ensure that related risks are and will be managed by entities. In general, the Commission should not diminish the importance of mandatory disclosure. This would be a missed opportunity to introduce a policy measure, which would not only provide useful information to capital market participants but could also cause a positive environmental and social impact through increased transparency.

c. Removing the mandatory status not only allows companies to selectively exclude data points but also increases the risks of incomplete and incomparable data, hindering investors' ability to align sustainability investment strategies. The voluntary approach provides a safe harbor for companies to avoid legal requirements and discourages investors from relying on reliable information.

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[8] In China: Chen, Hung, Wang (2018) (link); in the EU: Fiechter, Hitz, Lehmann (2022) (link)

[9] In the US: Bauckloh, Klein, Pioch, Schiemann (2022) (link), and Tomar (2023) (link), and in the UK: Downar, Ernstberger, Reichelstein, Schwenen, Zaklan (2021) (link).

[10] Christensen, Floyd, Liu, & Maffett (2017) (link)

[11] Cho, Lee & Pfeiffer (2013) (link); Schiemann & Sakhel (2019) (link)

[12] Dhaliwal, Radhakrishnan, Tsang, Yang (2012) (link); Schiemann & Tietmeyer (2022) (link)

[13] Dhaliwal, Li, Tsang, Yang (2011) (link)

[14] World Economic Forum – The Global Risks Report (2022) (link)