WHO IS GOING TO WIN: THE EU ESG REGULATION OR THE REST OF THE WORLD? – A CRITICAL REVIEW

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Abstract: *This paper aims to explore the past and the present challenges of EU ESG regulatory framework. Moreover, it attempts to make an in-depth analysis of the major ESG frameworks and standards used at a global level: GRI, SASB, IIRC, CDP, CDSB, TCFD, CSRD, and EU Taxonomy. The analysis considers 5 criteria: framework vs. standard, shareholder perspective, reporting format, metrics, and materiality. In addition, we draw insights into the complexity of the EU ESG reporting scheme and its added value compared to already existing frameworks and standards. Our results have implications on three levels: 1) for reporting companies that are faced with the option of selecting a reporting framework that will minimize the cost of compliance but also help them implement their climate transition strategy; 2) for employees and consumers of goods and services provided by companies that incorporate ESG in their long term economic activities and 3) policymakers that want to make sure they design the best standards that will ensure a smoother and effective transition to a low carbon economy.*

Keywords: ESG; SDG; sustainable finance; EU Taxonomy

JEL Classification: G11; Q56; D53; P34

1. Introduction

ESG as an integrated business concept and is relatively new. If we do a simple historical analysis in the databases for the academic citations, the ESG concept has been developed in terms of academic contributions since 2005 with much higher dynamics beyond 2010. Considering a simple search in the databases for academic citations with the keyword "ESG" in the fields of finance, management, economics, and sustainable development, about 60% of the academic contributions were created in the last 4-5 years (excluding 2021). These findings show that the concept of ESG is still at the growth stage in the life cycle of an integrated approach to the value creation of a company. The "ESG" concept and the terminology were first mentioned in the report "Who Cares Wins" (International Finance Corporation, 2005) issued by International Finance Corporation in association with the Global Compact in 2005. Later, in 2006 it was considered in the United Nation's Principles for Responsible Investment (PRI) report. Looking into these aspects, it is worth analyzing the relevancy of the academic contribution starting from 2007, as it is an obvious reaction of the academic community to the new approach of factor analysis of investment processes and decision-making. As Afolabi et al. (2022) shows, as long as the existence of a desire for the hegemony of the various regulators will persist, the harmonization of the sustainability reporting framework is not going to be any nearer. It was found that the European ESG regulatory framework is still young, compared with other non-financial initiatives, but its structure is complex as the European commitment towards sustainability is the most advanced at the global level. Not having a harmonized non-financial reporting system is creating problems for reporting entities and stakeholders in building a common understanding of the companies' sustainability performance.

Given the diverse methodologies on which sustainability standards are being constructed and integrated into the annual financial reporting of businesses the questions worth asking are: What is the added value of the EU ESG regulatory framework in the context of sustainability reporting? How is it different from the already existing frameworks and standards? What is the perspective of the stakeholders and of the companies operating in the European Market? This paper tries to answer these questions by performing a critical analysis of the most used ESG standards frameworks and the newly created EU regulations on ESG. Section 2 outlines the main regulations that govern the EU ESG reporting framework. In section 3 we perform an in-depth analysis of the main ESG regulatory standards and frameworks based on 6 criteria: purpose, framework vs. standard, reporting format, target audience, metrics, and materiality. Section 5 concludes with recommendations and limitations of our study.

2. The EU ESG regulatory framework

The European Commission has created a comprehensive policy agenda to promote sustainable finance in order to meet its objective of becoming carbon neutral by 2050. The 2018 10-point Sustainable Finance Action Plan intends to manage financial risks associated with environmental, social, and governance (ESG) challenges while directing capital flows toward sustainable initiatives.

The EU ESG framework is conceived under three pillars, in particular:

1. Non-financial disclosures - comprehensive disclosures for both financial and non-financial undertakings with the aim to provide investors with transparent information in the decision-making process.
2. The EU Taxonomy – a common classification for economic activities that are considered "green", by ensuring that companies contribute to the environmental objectives in a sustainable way.
3. Products & labels: preventing greenwashing for market participants, investors, and countries in order to develop sustainable investment solutions.

The NFRD (Directive 2014/95/EU) is one of the first regulations that introduced mandatory sustainability reporting for certain large companies operating in the EU. Its aim is to set mandatory reporting requirements for companies by publishing non-financial information related to their efforts to protect the environment, ensure diversity in their working environment, and mitigate against anti-corruption and bribery matters. The EU taxonomy is a classification tool which determines whether an economic activity is deemed environmentally sustainable or not. Its main purpose is to help investors, companies, and policymakers make more informed decisions by identifying activities that are believed to make a significant contribution to environmental goals and thereby help fund the transition to a more sustainable economy. By the same token, the EU taxonomy creates a common language in the field of sustainable development by setting clear standards to prevent greenwashing and enforcing them. The EU Taxonomy Regulation applies to: 1) financial market participants offering financial products in the EU, including occupational pension providers; 2) large companies that are already required to file a non-financial statement under the Non-Financial Reporting Directive (NFRD); 3) the EU and Member States when setting public policies, standards or labels for green financial products or green (corporate) bonds.

3. Analysis and Discussion

This section will focus on the analysis of the major frameworks and standards used by companies when reporting their ESG data. The study uses six criteria to extract insight into the added value of creating an ESG standard at the EU level. Table 1 depicts the parallel between the most used ESG reporting framework and schemes based on the five criteria mentioned above. It explores the difference between standard vs. framework, reporting format, and its targeted audience. Furthermore, it touches on complex issues like materiality and employed metrics that are susceptible to confusion among the reporting companies and policymakers.

3.1. Framework vs. Standard

An ESG framework has a broad scope and is meant to outline a “frame” to contextualize information and to set principles and guidelines when reporting sustainability data. It does not provide a specific methodology on how to collect and report data but it provides a certain flexibility in defining the desired direction. On the contrary, an ESG standard is very specific outlining criteria on how the data needs to be collected. Moreover, it has specific instructions and templates on how to report sustainability information. In this respect, standards are very efficient in making frameworks more practical because it does not only improve the reliability of data disclosed but also make it more comparable.
Frameworks can imply a voluntary disclosure in which companies actively disclose their ESG-related data. This is the case of CDP which collects data based on a standardized questionnaire on different issues related to sustainability. IIRC and TCFD are both based on voluntary disclosures and are more aimed at providing recommendations on climate change reporting. GRI, SASB and CDSB are considered standards as they provide clear metrics on disclosing issues related to environmental, social, and governance issues. ESG standards are preferable against frameworks because they foster transparency, effective reporting, and comparability. If companies have a clear methodology of measuring the impact of their economic activities, they are more likely to achieve greater carbon mitigation. This is even more crucial in weak institutional settings where national governments have less stringent regulations and people have lower climate change awareness (Luo and Tang, 2022). The new EU taxonomy and the CSRD will become EU standards in ESG reporting, a statement confirmed by the

European Parliament: “[The CSRD will] end greenwashing, strengthen the EU’s social market economy and lay the groundwork for sustainability reporting standards at global level.” (EP, 2022).

Given the new EU ESG regulations, it will become increasingly burdensome for companies that operate in international markets to report based on different standards. A KPMG survey showed that 73% of the largest 250 global companies are using the GRI standards when reporting sustainability data (KPMG, 2020). As the EU regulations will be transposed in Member States, the cost of compliance could deter companies from reporting based on their usual standard, making EU ESG a worldwide standard. It could also influence regulation at the global level laying the ground for regulatory arbitrage (Rocio et de Mariz, 2022) or as Kate Vyvyan from Clifford Chance termed it “taxonomy shopping” (Global Capital 2021). Currently, under the existing ESG frameworks and standards, carbon emissions are disclosed on a voluntary basis or are mandated by some regulations in force. In the case of EU taxonomy, ESG disclosure will be mandatory which can generate effects on the way companies behave in relation to their sustainability strategy. In fact, the latest research shows that mandatory disclosures led to an economically significant reduction of greenhouse gas emissions in the UK (Downar et al., 2020). Similar findings have been registered in the US (Tomar, 2019). In China, Chen et al., (2018) shows that mandatory reporting on ESG data generates lower levels of pollution in the local area with lower levels of profitability.

3.2. Reporting format

The most common report used by companies is called the Annual report and is meant to produce only financial data related to the performance of the company during the reporting year. The ESG or Sustainability report allows companies to provide relevant ESG data in one document that was specifically built for sustainability data reporting. Integrated reporting combines both financial and sustainability data with the purpose of showing its stakeholders how sustainability matters are connected to the business model the company strives to achieve. Independent ESG reporting and integrated reporting have their advantages and disadvantages. To name a few, independent ESG reporting allows companies to share as much information as necessary about their long-term strategy on sustainability or achievements. A study on Japanese companies showed that firms that follow ESG guidelines disclose 39% more data on sustainability than firms that publish ESG data in integrated reporting (Darnall et al., 2022). The amount of data disclosed in ESG reporting has been proven to be linked with the economic performance, size, leverage, and profitability of firms (Rahman and Alsayegh, 2021). Moreover, it’s more appealing to stakeholders that are more interested in ESG data and not in financial achievements. On the other side, independent ESG reporting can have its downsides. It can downturn early investors that only look at the annual financial report and are not aware of the existence of a sustainability strategy. Integrated reports usually need a green light from the board of investors that ultimately leads to cooperation between the ESG and Finance departments. Moreover, in integrated reports, sustainability is dependent on annual financial reporting. For this reason, integrated reporting supports the commitments of companies to report both financial and ESG data in the same time frame.

Table 1. Differences between the most used ESG reporting frameworks and standards

	GRI	***SASB***	***IIRC***	***CDP***	***CDSB***	***TCFD***	***EU ESG regulations***	
							EU Taxonomy	***NFRD/ CSRD***
Purpose	Focuses on helping organizations communicate about sustainability topics and their impacts, along with how these impacts are managed at the organizational level.	Focuses on developing and disseminating sustainability accounting standards that help public corporations disclose material, decision-useful information to investors.	Aims to create a globally accepted framework for reporting on value creation over time.	Addresses the creation of a sustainable economy by measuring and acting on the environmental impact of the company's activities.	Targets the applicability of traditional financial accounting, and reporting standards to guidelines on disclosure about climate, natural capital, and environmental information.	Focuses on helping organizations disclose information about the financial impacts related to climate change risks and opportunities.	Provides companies, investors, and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable.	Make non-financial information available to stakeholders and investors to determine the companies' value creation and risks, and encourage society to take responsibility for social and environmental concerns.
Standard/ Framework	Standard	Standard	Framework	Framework	Standard	Framework	Standard	Standard
Reporting format	ESG reporting	ESG reporting	Integrated reporting	Integrated reporting	Annual & integrated reporting	Integrated reporting	ESG reporting	ESG reporting
Target audience	Investors - internal and external to the reporting organization	Shareholders and other providers of capital, communities, customers, employees, suppliers, civil society, governments, investors, lenders, rating agencies, and insurance underwriters.	Investors - internal and external to the reporting organization	Investors, purchasers, and city stakeholders	Investors and financial markets	Investors, lenders, and insurance underwriters ("primary users")	Investors, lenders, policymakers, governments,	Investors, lenders, civil society
Metrics	Combination of qualitative and quantitative information.	Combination of quantitative (benchmarking within the industry and historical performance) and qualitative data.	Combination of quantitative (KPI) and qualitative data.	Quantitative and qualitative data	Quantitative and qualitative results, together with the methodologies used.	Quantitative and qualitative data	Quantitative and qualitative data	Quantitative and qualitative data
Materiality	Double materiality: measures company's performance and the material impact that the company has on its external environment	Impact materiality: Sustainability issues that have a material impact on the financial performance of the company	Impact materiality: reporting on activities that have a material impact on the organization's ability to create value.	Double-materiality: assessing the impacts of the company («inside-out») and («outside-in»)	Single materiality: reporting on data related to environment and climate change	Double materiality: reporting on financial and natural capital	Double materiality: achievement of objectives and DNSH principle	Double materiality: financial and social and environmental impact of the company

Source: Authors' own elaboration

There are however disadvantages when it comes to integrated reporting. Most of them are related to the cost of compliance for reporting companies as they need to gather sufficient knowledge on ESG indicators and their implementation in the real life of the organization. It can also lead to greater stress for the organization due to tighter deadlines as sustainable data needs to be presented at the same time as financial data.

3.3. Target Audience and Shareholder's Perspectives.

Financial reporting has been usually addressed to investors while non-financial reporting and ESG reporting can be targeted to all stakeholders involved, be it civil society, employees, policymakers, or rating agencies. To better present the ecosystem of sustainable development interactions between players/stakeholders we are going to remodel the framework proposed by de Souza Cunha (2021). Table 2 illustrates the idea of this framework which is going to reveal generically three important pillars that interact to build a solid ground for sustainable development: sustainable capital, the regulatory framework for sustainable development, and the stakeholder's perspective.

Table 2. Stakeholder perspective of sustainable finance.

	Providers of sustainable finances	**Beneficiaries of sustainable finances**	**Supporters of sustainable development**	**Beneficiaries sustainable development**
Market participants	Investors and financial institutions	Corporations / Financial institutions	Governments, NGOs, stock exchanges, Regulatory Financial Authorities, Rating Agencies etc.	Civil society, Business community and environment
Regulatory Framework	GRI, SASB, IIRC, CDSB, TCFD	GRI, SASB, IIRC, CDSB, TCFD	GRI, NFRD/CSRD, EU Taxonomy	GRI, NFRD/CSRD, EU Taxonomy, SASB
Strategies	Internalization of sustainability	Internalization of sustainability	Assurance of sustainable development regulatory ecosystem	To monitor and challenge the sustainable finance market improvement
Performance and metrics for sustainable finances	Risk-adjusted returns, increased public reputation and image	Lower cost of capital, improved corporate performance	The non-financial regulatory framework, standards for sustainable finance, rating, indexes, etc.	Achievement of sustainability targets.

Source: Authors' adaptation based on De Souza Cunha et. al, 2021

Providers of sustainable capital are those that trigger the transformation process. They are willing to have such reporting framework and monitoring system for sustainability performance from the perspective of risk-return profile. Such a system will provide but will not guarantee a lower business risk, a better risk-return performance, and a better reputational image. According to Eurofis report 2021, the past years were commercially favourable for ESG investments in terms of performance and growth in assets. Interestingly, this information was extracted from reports structured according to SFDR especially Article 8 "light green" or Article 9 "dark green".

Next, the beneficiaries of green finance are those that are seeking to implement the corporate sustainable development strategy. For this reason, they should have to set up “green projects” and obtain investment capital at lower financing costs. The beneficiary perspective should be considered in the process of creating sustainable development policies. Supporters of sustainable development are those that create the policies and regulatory framework. In the regulatory process, they put together and should represent the interests of all stakeholders. The beneficiaries of sustainable development initiatives are the most complex structure of stakeholders (e.g. civil society, employees, customers, etc.) which must be treated very carefully both in the process of setting up the regulatory framework and in assessing correctly the impact materiality.

Considering a stakeholder’s perspective, the policymakers should internalize in their strategy the full commitment and continuous improvement approach. For example, the regulatory body should strengthen the stewardship and engagement framework of the Shareholder Rights Directive II and concentrate more on the outcomes. Therefore, they proposed a Renewed sustainable Finance strategy instead of having only “comply-or-explain” to have implemented engagement policies and activities for sustainability performance assessment, control, and corrections (Eurosif Report, 2021).

Referring to the above, some regulatory setters are considering the multi-stakeholder view when preparing the non-financial regulatory framework (e.g. EU Standard setters, GRI), and some of them only present the investors/firms interests (e.g. IIRS, SASB). In this respect, the EU Taxonomy and the CSRD bring added value to all stakeholders as it aims at creating a common language that investors and business can use when investing in different economic activities. It focuses on increased transparency and disclosure of non-financial information that in turn fosters incentives for the private sector to invest in the production of low carbon goods and services. It also aligns Member States on their national policies related to climate transition and attempts to educate communities and people about concepts like climate change, sustainable investments, and green performance.

3.4. Metrics

The main aim of ESG disclosure is to capture, as accurately as possible, the performance of the company in relation to its impacts on the environment and people affected by its economic activities. Most frameworks and standards analyzed in this paper provide a combination of quantitative and qualitative metrics. Given the multitude of frameworks and standards, it becomes increasingly difficult for all stakeholders involved to benchmark indicators reported in disclosures. Inconsistencies have been reported in the way companies report their data related to specific indicators. As the metrics are different depending on the framework used, the indicators become difficult to compare between companies from the same sector if the indicator employs different units of measure. Kotsantonis and Serafeim (2019) showed that ESG data is inconsistent and difficult to compare among different frameworks and standards. This in fact, not only affects the performance of the company but also its ability to minimize negative impacts on the environment.

There are also differences in process-focused verification versus content-focus verification. While the former deals with the rules and standards that need to follow in their disclosure, the latter deals with the accuracy, and completeness of ESG data reported. GRI, SASB, CDP, IIRC, and CDSB all use process-focused verifications. Content-focused verification has been proven to be more robust as it aims to improve data quality and substance. According to Darnall et al., (2022) content-focused verification generated greater information disclosure among Japanese firms. It has also been documented that these publish 23% more content in their ESG reporting. The study draws on the idea that ESG reporting and standards need to focus more on content-focused verification than process-focused verification to stimulate companies to disclose more data that will ultimately lead to higher sustainability. This has major implications for the effects of EU ESG regulatory framework implementation. As the EU taxonomy focuses on clear criteria to distinguish sustainable activities, it can lead to a more robust disclosure among companies operating in the European market.

3.5. Materiality

Companies use the materiality assessment to filter in data that is relevant to the company, and which supports stakeholder and strategic decision-making. From this aspect, materiality does not have a clear definition and has led to multiple interpretations when dealing with disclosure reporting in various organizations. For example, GRI gives a different interpretation of the term, in the sense that it is more focused on stakeholders rather than investors. GRI questions what material impact has the reporting company on its external environment. However, it does not provide guidelines on how to assess this materiality but rather leaves it to the willingness of the reporting company to define its specific methodology. On the other spectrum, SASB standards regard materiality as a sustainability issue that can have an impact on the financial performance and position of the company.

Both standards discussed above use the so-called “impact materiality” which considers the impact that activities may have on the environment in the short, medium, or long term. This includes the impacts of the organization on the upstream or downstream of its value chain (ESRG, 2022). As it concerns IIRC, materiality needs to be reported based on those activities that “substantively affect the organization’s ability to create value over time” (IIRC, 2013). Their disclosure also focuses on impact materiality as GRI and SASB.

The concept of ‘double-materiality’ was first coined by the European Commission (European Commission, 2019) in Guidelines on Non-financial Reporting: Supplement on Reporting Climate-related Information. In this sense, materiality needs to be understood from two angles: (1) development and performance that determine the values of the company and (2) the impacts on stakeholders that a company can have related to social and environmental domains. By this token, the European Financial Reporting Advisory Group (EFRAG) defines double materiality as “financial materiality” and “impact materiality”. This reflects on the EU ESG regulatory framework put in place in the last years and it will be binding for companies operating in the EU. The EU taxonomy adopts a “double materiality” concept which demands that a company assesses its activities that help meet the objectives laid down in the regulation but also that it does no significant harm to the other. In essence, companies need to screen their activities not only inside-out to evaluate their impact on the environment but also outside-in to cater their long-term strategy to include climate change challenges. Companies need to have a double view of their data and indicators. Additionally, the CSRD follows a double materiality concept focusing not only on reporting financial data but also on the social and environmental impact of the company's activities.

4. Conclusions and Recommendations

This paper explores past and present challenges of EU sustainability reporting framework. Moreover, it examines the directions of European ESG regulatory framework development in order to achieve the climate and sustainable development targets. It is worth mentioning that at the global level there are two opposite forces that hamper the sustainable development of nations: on one hand there is a conflict between various international "actors" (regulators) to maintain their influence and technical superiority in the contested regulatory area where the expertise hegemony is unacceptable; on the other hand, there are nation's commitments and desire towards climate change for 2030 and 2050. These conflicting forces generate some drawbacks of having different ESG regulatory frameworks and initiatives:

1. There is no consistency between different non-financial reporting frameworks in preparing the information for the stakeholders (e.g., financial stakeholders vs multiple stakeholders vs non-financial stakeholders).
2. Different formats of sustainability reports; stand-alone reports vs integrating reports bring the following specifics:
   - More time flexibility and granularity in providing independent ESG reporting
   - Difficulties for stakeholders to identify the value impact of sustainability risks in the financial statements
   - Integrated approach in preparing the ESG reports, and accountability from Board members for both financial and ESG performance (also these reports are one stop shop).
   - Higher costs of compliance, difficulties to understand the combined financial and ESG information, and less flexibility in preparing the reports.
3. Sustainability reporting driven by financial materiality and promoted by, for example, the accountancy community through (e.g., IFRS Foundation) might have an insignificant or negative impact on sustainable development.
4. Different scopes driven by IFRS Foundation and European Financial Reporting Advisory Group EFRAG show resistance and a lack of desire for harmonization in ESG reporting. EFRAG has an interest to drive sustainability through impact change in a "framework" of dynamic materiality while IFRS Foundation is interested mainly to protect investors by focusing on enterprise value creation and less importantly the disclosure of impact materiality aspects.
5. In this turbulent and unclear regulatory development direction there are disadvantages: the high cost of compliance, and sustainable development is slowing down.
6. As ESG is an important non-financial driver for corporate value creation and corporate performance, non harmonized regulatory framework might have a negative impact on capturing and monitoring the corporate ESG performance (mostly quantified through ESG indexes). There is a growing academic literature that provides evidence of divergences and inconsistencies between

ESG ratings (e.g., Berg et al., 2019, show that the correlation between ESG raters ranges between 0.42 and 0.73).

7. Because of the legislative power of EFRAG and the backing of the European Commission there is a significant concern that the sustainability (ESG) regulatory process is hampered by the political interferences: (e.g., various political decisions, power interplay, and influences that may occur behind the scenes).
8. By having different approaches towards non-financial/sustainability reporting the risk for greenwashing is increasing fact that negatively influences the investment decision making process in the sustainable development projects and Initiatives.

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