The Sustainability Reporting Ripple: Direct and Indirect Implications of the EU Corporate Sustainability Reporting Directive for SME Actors

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A. INTRODUCTION

Demand for ESG metrics is driven by market, societal and regulatory sensitivities. With the first iteration of EU sustainability reporting having taken place under the Non-Financial Reporting Directive),[1] the momentum for a new and improved second iteration arose as an integral part of the European Union's grand plan for a just transition to a fair and sustainable economic system. The European Green Deal[2] and the Sustainable Finance Action Plan,[3] acting as mutually reinforcing forces, have propelled the European Commission's legislative agenda in the field of corporate sustainability including sustainability reporting. To influence private financial flows in the right direction towards sustainable investment requires being able to separate the wheat from the chaff in terms of companies' ESG records. Furthermore, although it is perhaps too early in the life of sustainability reporting to demonstrate a solid correlation between corporate sustainability performance and profitability, the two are being linked to form a virtuous circle.[4] The availability of meaningful reporting on sustainability data that provides appropriate insights about companies and financial institutions is pivotal to allow sustainable financial decision-making and investments to be made on a sound footing. However, at a policy level, defining reporting requirements for sustainability statements that are both meaningful and manageable represents a very big nut to crack.

The journey which the European Union has been on from its first engagement with corporate social responsibility as a concept to sustainability reporting is legislatively bookended by the adoption of the Non-Financial Reporting Directive providing for non-financial reporting on the one hand, and on the other, by its eventual replacement with upgraded sustainability reporting in the Corporate Sustainability Reporting Directive (the 'Corporate Sustainability Reporting Directive').[5] The Corporate Sustainability Reporting Directive's provision for sustainability reporting comes with the clear objective of replacing the Non-Financial Reporting Directive's reporting framework in the Accounting Directive[6] with one of far greater ambition. Indeed, a key objective of the Corporate Sustainability

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1 Directive (EU) 2014/95/EU on the disclosure of non-financial and diversity information (the Non-Financial Reporting Directive or 'NFRD') L 330/1.

2 Communication from the Commission on the European Green Deal, COM(2019)640 final, 11 December 2019; Commission Work Programme 2020: A Union that Strives for More, COM(2020) 37 final, 29 January 2020.

3 European Commission, *Action Plan: Financing Sustainable Growth* COM/2018/097 final.

4 M Taliento, C Favino and A Netti, 'Impact of Environmental, Social, and Governance Information on Economic Performance: Evidence of a Corporate 'Sustainability Advantage' from Europe'. (2019) 11(6) Sustainability 1738. See generally K Raworth, *Doughnut Economic: Seven Ways to Think Like a 21st Century Economist* (Chelsea Green Publishing 2017).

5 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 (the 'Corporate Sustainability Reporting Directive' or 'CSRD') L 322/15.

6 Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of

Reporting Directive is to lay down a framework that will enable sustainability reporting concerning corporate environmental and societal impact to achieve equivalence with financial reporting. Once sustainability reporting under the Directive is up and running, in line with objectives also seen in the Taxonomy Regulation[7] and the Sustainable Finance Disclosure Regulation,[8] stakeholders including lenders and investors will benefit from being able to access standardised digitally tagged data within the planned European Single Access Point Database.[9] Central to the Corporate Sustainability Reporting Directive will be the associated adoption of European Sustainability Reporting Standards.

As well as providing some overall impressions of the Directive's significance, the more particular objective is to bring within the frame some contextualised perspectives on what the Corporate Sustainability Reporting Directive and its roll-out of sustainability reporting mean within the context of the impact on small and medium sized enterprises ('SMEs' in the European Union. An assessment of SME-related implementation issues concerning the Corporate Sustainability Reporting Directive is timely as Member States work to transpose the Directive by 6 July 2024[10] and companies are working to prepare processes to handle the arrival of reporting under European Sustainability Reporting Standards.[11] The SME context is significant. It would be a mistake to regard the expanding prism of sustainability in the Corporate Sustainability Reporting Directive as confined to larger undertakings. It is true that the Directive will only directly affect SME companies that have securities listed on regulated markets. However, the indirect impacts of the ripples cast by the Corporate Sustainability Reporting Directive are far wider. Consequently it is not only companies that are directly within the scope of the Corporate Sustainability Reporting Directive and obliged to report under it that will be impacted by it. As discussed below, the introduction of value chain reporting means that information will be requested by in scope actors from their upstream and downstream suppliers and business partners. In the European Union many of these will be SMEs and micro-undertakings. This means that the Corporate Sustainability Reporting Directive will exert a wide circle of indirect influence that will act as a catalyst for value chain and supply chain actors to also examine their part in the sustainability equation. It is argued here that the indirect, trickle-down impacts of the Directive on SMEs value chain actors upstream and downstream from regulated reporting companies will be momentous and costly to respond to or ignore. As such, assistance and understanding from other regulatory actors and states is crucial.

Part B contextualises the EU momentum towards sustainability. It begins with some reflection on the evolution of corporate social responsibility ('CSR') and how CSR over time became a policy matter for the EU amid a journey towards the sustainability imperative. From that vantage point we move to look at the impact and perceived shortcomings of the Non-Financial Reporting Directive. From there the

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the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC (the 'Accounting Directive') L182/19.

[7] Regulation 2020/852/EU of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (the 'Taxonomy Regulation').

[8] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector OJ L317/1 (the 'Sustainable Finance Disclosure Regulation' or 'SFDR').

[9] Electronic reporting feeds into a broader objective to introduce digital tagging of reported information so that it is machine readable. This in turn feeds into the EU's desire to realise a single access point for reporting which is a component of Capital Markets Union Action Plan. However, to realise this the EU must formulate a digital taxonomy that will apply to EU Sustainability Reporting Standards. Provisional agreement on the European Single Access Point ('ESAP') was reached by the Council and the European Parliament on 23 May 2023. This will provide freely available digital access to financial and sustainability information. It is envisaged that the platform will be made available on a phased basis in 2027. <https://www.consilium.europa.eu/en/press/press-releases/2023/05/23/easy-access-to-corporate-information-for-investors-provisional-agreement-reached-on-the-european-single-access-point-esap/> accessed 30 June 2023.

[10] Member States will have to set up mechanisms for national supervision of sustainability reporting.

[11] Staggered reporting under the Corporate Sustainability Reporting Directive begins with reporting in 2025 on 2024 financial year for companies already subject to the Non-Financial Reporting Directive. Then large companies not currently within the Non-Financial Reporting Directive must report in 2026 on their 2025 financial year. Listed SMEs (along with small and non-complex credit institutions and captive insurance undertakings) begin simplified reporting in 2027 on their 2026 financial year. Lastly, non-EU companies meeting certain thresholds begin reporting on their 2028 financial year in 2029.

journey to the adoption of the Corporate Sustainability Reporting Directive as the conduit for new and improved sustainability reporting amid building EU momentum is examined. Part C contextualises the commercial importance of SMEs in the European Union, preparing the ground for subsequent consideration of how the European Union's expansive policy revisions on sustainability reporting will impact on SMEs. Part D considers the Corporate Sustainability Reporting Directive's widening regulatory net in relation to the undertakings required to engage with sustainability reporting. From there, Part E engages with the sustainability matters that must be reported on and the likely impact on the SME sector. Parts F and G explore the implications of the evolving development of European Sustainability Reporting Standards including both mandatory standards for the listed SME sector and voluntary standards being developed for the broader non-listed SME sector. Part H reflects upon the challenges for EU SMEs as value chain actors while the Conclusion offers some general observations on the likely impact of the EU's sustainability reporting regime.

B. EU MOMENTUM TOWARDS SUSTAINABILITY

The Non-Financial Reporting Directive was always set to have its effectiveness reviewed, but the evolving EU sustainability policy backdrop against which its revision took place ultimately shaped the overall motivation of the Corporate Sustainability Reporting Directive. Understanding the impetus behind the advancing reach of sustainability reporting in the European Union involves an appreciation of how EU ambition in this field has gradually expanded over time. The concepts in question have been around for a long time and are familiar territory to business ethics scholars who have been talking about corporate responsibility matters and reporting for a long time.[12] Then sustainability reporting emerged in the market to provide 'triple bottom line reporting' – on people, planet and profit. While sustainability reporting became commonplace in larger companies, the absence of regulation led to a *laissez-faire* approach to the existence and content of such reports by companies that permitted greenwashing.[13]

EU company law and corporate governance policy has played an incrementally expanding role in mainstreaming sustainability as core to mission over time. In this regard, there has been a considerable shift in policy approach at EU level over time. A number of distinct phases are identifiable. During the 'Voluntary Phase' the EU's stance on corporate social responsibility ('CSR') regarded it as entirely voluntary for companies.[14] Subsequently, in the 'Moral Responsibility Phase', dating from the Commission's renewed CSR strategy in 2011,[15] the European Commission moved on from regarding CSR as voluntary and instead emphasised both the moral and the legal responsibility of companies for their impact on society. This dovetailed with the post-financial crisis EU policy narrative on sustainability as a long-term driver of the social market economy as the financial crisis had showed everything that was broken with a short-term profit corporate agenda. Reflecting this, the objective of the Non-Financial Reporting Directive was to improve transparency and accountability around ESG matters so as promote sound business models and investor confidence.[16]

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[12] The pre-eminent among these is RE Freeman in his championing of stakeholder theory including his seminal work, RE Freeman, *Stakeholder Theory: The State of the Art* (Cambridge University Press 2010).

[13] WS Laufer, 'Social Accountability and Corporate Greenwashing' *Journal of Business Ethics* (2003) 43 *Journal of Business Ethics* 253; W Breuer and M Hass, 'All That Glitters is Not Gold: Performance Impact of Corporate Greenwashing' (29 April 2022) <http://dx.doi.org/10.2139/ssrn.4096853> accessed 30 June 2023. The problem also extends to consumer claims: G Marcatajo, 'Green Claims, Green Washing and Consumer Protection in the European Union" (2023) 30(1) Journal of Financial Crime 143 <https://doi.org/10.1108/JFC-11-2021-0240> accessed 30 June 2023.

[14] European Commission, *Green Paper: Promoting a European Framework for Corporate Social Responsibility* COM(2001) 366.

[15] European Commission, *A Renewed EU Strategy for Corporate Social Responsibility* COM(2011) 681 final 6.

[16] D Ahern, 'Turning Up the Heat: CSR Reporting, Sustainability and the Parameters of Regulated Autonomy in the European Union' (2016) 13(4) European Company and Financial Law Review 599.

We are now in phase three of the European Union's regulatory policy approaches, the 'Green Deal and Sustainable Finance Policy Phase'. In this phase, the sustainable corporate governance and sustainable finance agenda has been building momentum and continues to do so.[17] In 2015 the adoption of the United Nations 2030 Agenda and its Sustainable Development Goals[18] expressed the urgent need to move towards sustainable development. We also had the seismic Paris Agreement on Climate Change in the same year.[19] Then in 2019 the European Green Deal set out the European Commission's commitment to tackling climate and environmental-related challenges as being **'**this generation's defining task'.[20] In line with this, the EU has forged ahead with a sustainable finance agenda.

In the 'Green Deal and Sustainable Finance Policy Phase', the Commission has stepped up to go full throttle on sustainability, the culmination of which will be the adoption of the Corporate Sustainability Due Diligence Directive. While the intricacies of the landslide policy movement in the EU towards sustainable finance are composed of many moving parts, for present purposes what matters most is that the economic, corporate and financial risks of continued unsustainability have been laid bare and have driven an ambitious EU sustainability policy agenda. Within this movement, companies and boards as their fiduciary agents are seen as having an instrumental role in the transition to sustainable finance. A number of significant legislative landmarks in the EU sustainable finance agenda are worthy of mention. These include the adoption in 2019 of the Sustainable Finance Disclosure Regulation[21] to enhance credibility and transparency in the market for sustainable investment products. The Sustainable Finance Disclosure Regulation requires sustainability disclosures from financial market participants including asset managers and financial advisors which in turn means that they need to obtain relevant sustainability information from investee companies. The arrival of the Taxonomy Regulation[22] has provided a means of indicating the extent to which financial products are environmentally sustainable in nature. This has led to the publication of a number of delegated Acts including the EU Taxonomy Climate Delegated Act, a delegated act being adopted on sustainable activities for climate change adaptation and mitigation objectives.[23]

This regulatory policy phase has coincided with the revision of the Non-Financial Reporting Directive and negotiations on the Proposal for a Corporate Sustainability Due Diligence Directive.[24] It is within this expansive phase that both the substantive obligations on companies and their indirect impact on many other supply and values chain actors are set to increase exponentially. In the Commission's Communication on the European Green Deal, the Commission pledged to review the Non-Financial Reporting Directive as an integral part of the strategy to strengthen the backdrop for sustainable

[17] See further IHY Chiu, 'The EU Sustainable Finance Agenda: Developing Governance for Double Materiality in Sustainability Metrics' (2022) 23 EBOR 87.
[18] <https://sdgs.un.org/2030agenda> accessed 30 June 2023.
[19] Paris Agreement under the United Nations Framework Convention on Climate Change adopted on 12 December 2015.
[20] European Commission, Communication from the Commission: *The European Green Deal* COM (2019) 640 final, Introduction.
[21] (n 8).
[22] (n 7). See also 2019/2089/EU amending Regulation 2016/1011/ EU as regards EU Climate Transition Benchmarks, EU Paris-Aligned Benchmarks and sustainability-related disclosures for benchmarks OJ L317/17 (the 'Low Carbon Benchmarks Regulation: Regulation').
[23] Commission Delegated Regulation 2020/2139/EU of 4 June 2021 supplementing Regulation 2020/852/EU by establishing the technical screening criteria for determining the conditions under which an economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation and for determining whether that economic activity causes no significant harm to any of the other environmental objectives OJ L188/1 (the 'Climate Delegated Act'). On 27 June 2023, the European Commission adopted a Taxonomy Environmental Delegated Act in relation to non-climate-related environmental objectives which is awaiting publication in the Official Journal.
[24] European Commission, Proposal for a Directive of the European Parliament and of the Council on Corporate Sustainability Due Diligence and amending Directive (EU) 2019/1937 COM/2022/71 final, Brussels, 23.2.2022 (the 'Corporate Sustainability Due Diligence Directive' or 'CSDD').

investment in the Union. The Sustainable Finance Action Plan[25] also provided a mandate for reviewing the operation of the Non-Financial Reporting Directive, emphasising that a suitable balance had to be struck between giving flexibility to businesses and the need for standardisation of disclosures. For the EU Green Deal to successfully propel the markets for green investments, investors need reliable sustainability information to make green investments and to meet their disclosure requirements under the Sustainable Finance Disclosure Regulation. Thus the Corporate Sustainability Reporting Directive dovetails well with a suite of EU measures such as the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation also designed to aid transparency and comparability of sustainability information.

The Corporate Sustainability Reporting Directive emerged from the Commission's mandated fitness review of the Non-Financial Reporting Directive.[26] This author has previously contended that the primary success of the Non-Financial Reporting Directive was 'to mainstream sustainability disclosures within broadly defined parameters'[27] for large public interest entities. This is indeed important. The Non-Financial Reporting Directive started small and is best viewed as a starting point on the road to sustainability reporting, not an end point. This explains in part why a number of shortcomings around its operation were evident. It was expected that reporting would include a description of the business model, policies and related due diligence and that it would outline principal risks and how they are managed. It was also expected that policy outcomes would be discussed.[28] However, at its core, the minimum content in terms of ESG matters that companies needed to report on was quite vaguely outlined in the Directive. Companies were required to include material internal and external impacts on 'environmental, social and employee matters, respects for human rights, anti-corruption and bribery matters'.[29] The Non-Financial Reporting Directive's functionality was also impaired by it not seeking to be prescriptive in terms of drilling down to provide actual standards to be complied with. Further weaknesses surrounded the lack of mandatory external assurance (auditing).[30]

Significantly, a fundamental regulatory design choice made in the Non-Financial Reporting Directive was that non-financial reporting would not be mandatory.[31] The regulatory design was based on report or explain disclosure that lay between mandatory and voluntary regulation as companies could choose not to disclose and simply provide an explanation as to why they did not have a policy in the relevant area. 'Comply or explain' regimes, familiar in corporate governance codes are famously open to corporate governance actors choosing uninformative boilerplate responses and spurious explanations for why compliance does not seem relevant to a company's position. Indeed, companies who are averse to sustainability reporting rather than embracers have been shown to use boilerplate disclosures as a tactical avoidance mechanism.[32]

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[25] European Commission, *Action Plan on Financing Sustainable Growth* (COM/2018/097 final. See also European Commission, *Strategy for Financing the Transition to a Sustainable Economy* (COM/2021/390 final). On 23 June 2023 the European Commission published a sustainable finance package of measures to build upon the existing EU stainable finance framework <https://finance.ec.europa.eu/publications/sustainable-finance-package-2023_en> accessed 30 June 2023.

[26] Report from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the review clauses in Directives 2013/34/EU, 2014/95/EU, and 2013/50/EU, and accompanying SWD- Fitness Check.

[27] Ahern (n 16) 628.

[28] Accounting Directive (n 6), Art 19a(1) (as inserted by Art 1(1) of the NFRD (n 1)).

[29] ibid.

[30] There was no mandatory obligation on Member States to provide for verification by an independent assurance services provider.

[31] Accounting Directive (n 6), Art 19a(1) (as inserted by Art 1(1) of the NFRD (n 1)). The NFRD contained the following statement: 'Where the undertaking does not pursue policies in relation to one or more of those matters, the non-financial statement shall provide a clear and reasoned explanation for not doing so'.

[32] R Breijer and RP Orij, 'The Comparability of Non-Financial Information: An Exploration of the Impact of the Non-Financial Reporting Directive (Non-Financial Reporting Directive, 2014/95/EU)' (2022) 19(2) Accounting in Europe 322 DOI: <10.1080/17449480.2022.2065645>.See also S Pizzi, A Venturelli, and F Caputo, 'The "Comply-or-explain" Principle in Directive 95/2014/EU. A Rhetorical Analysis of Italian PIEs' (2020) 12(1) Sustainability Accounting, Management and Policy Journal 30 <https://doi.org/10.1108/SAMPJ-07-2019-0254>.

There was a desire by EU institutional actors to plug gaps, including those identified by stakeholders during the Commission's consultation on the Non-Financial Reporting Directive.[33] The clear message from that was that the quality and comparability of reporting needed to be improved, a message that was emphasised by the Council when in 2019 it requested the European Commission to look at developing a European non-financial reporting standard which is now framed by the Corporate Sustainability Reporting Directive. Following momentum to revise the Non-Financial Reporting Directive, the Commission's Proposal for a Corporate Sustainability Reporting Directive[34] was published in 2021 and after the legislative process, the Corporate Sustainability Reporting Directive entered into force on 5 January 2023. Framed upon reflection on the shortcomings of the Non-Financial Reporting Directive, the Corporate Sustainability Reporting Directive was designed to better empower investors and other stakeholders such as NGOs to assess sustainability risks. As a consequence, the previous reporting framework is replaced with one of greater breadth, depth and rigour in terms of undertakings within scope and the nature of reporting requirements imposed.

The Corporate Sustainability Reporting Directive's arrival ought to be contextualised in terms of its replacement of non-financial reporting under the Non-Financial Reporting Directive with mandatory European sustainability reporting in accordance with European Sustainability Reporting Standards. The associated recharacterization as sustainability reporting rather than 'non-financial reporting' speaks to the significance of sustainability matters in financial terms as well as in ESG terms. The change of terminology is culturally significant; the move from using the term 'non-financial information' reporting, to 'sustainability reporting' is made with a view to, firstly, placing sustainability reporting on an equal footing with financial reporting, and secondly, recognising that sustainability has both financial risk and opportunity implications. This fits with the regulatory decision to situate mandatory sustainability statements in the management report. The reporting regime will be beefed up by the addition of a mandatory audit of reported information. However, in accordance with Article 26a[35] at the outset this will commence with a 'limited' assurance requirement for the first 6 years. This is less onerous and less costly for companies than a full reasonable assurance requirement would be. In the meantime it is hoped that the market for sustainability audit services will evolve and that associated standards will be developed.

C. THE COMMERCIAL IMPORTANCE OF SMEs IN THE EUROPEAN UNION

The Corporate Sustainability Reporting Directive has (i) significant direct impacts on listed SMEs and (ii) inestimable indirect impacts on a vast swathe of SME value chain actors. SMEs constitute around 99 percent of all enterprises by number in the European Union,[36] and as such their specific circumstances matter when evaluating the impact of the Corporate Sustainability Reporting Directive in terms of both direct and indirect impacts. Before examining the implications for SME actors, this Part seeks to contextualise the commercial significance of these economic actors within the single market.[37] The European Union has approximately 25 million SMEs that are at the epicentre of the EU's economy, accounting for more than 50 per cent of the region's GDP and providing around 100 million

[33] European Commission, *Summary Report of the Public Consultation on the Review of the Non-Financial Reporting Directive* (2020).

[34] European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting COM/2021/189 final, Brussels, 21.4.2021 (the 'CSRD Proposal').

[35] Accounting Directive (n 6), Art 26a (as inserted by Art 1(15) of the CSRD (n 5)).

[36] See the European Commission's webpage <https://single-market-economy.ec.europa.eu/smes/sme-definition_en> accessed 30 June 2023.

[37] A consideration of SME actors in third countries lies outside the scope of this work.

people with employment.[38] The markets in which SMEs are involved is diverse and there has been increasing internationalisation of SMEs in reaching export markets, not just in the EU but also third country markets outside it, often benefiting from Free Trade Agreements that eliminate tariffs.[39] In short, SMEs are the heart of entrepreneurship and key drivers of the EU economy. The diversity and breadth within the SME population maintains relevance when it comes to judging capacity to adapt to the green transition and the challenges presented by the Corporate Sustainability Reporting Directive and the wider green deal agenda.

The European Union has set down rules to determine which undertakings qualify as micro, small and medium-sized enterprises ('SMEs'). These use average number of employees, net turnover[40] and balance sheet total in the financial year as objective indicators to classify entity size. For the purposes of sustainability reporting, regard must be had to Article 3 of the Accounting Directive[41] which classifies undertakings by size. Following a 2008 non-legislative resolution of the European Parliament requesting the Commission to review the impact of EU accounting requirements on small and medium-sized companies, but especially micro-undertakings given the associated administrative burden imposed.[42] Categorisation of undertakings progressively by size derives from the benchmarks contained in Article 3 of the Accounting Directive. Under this framework, a micro-undertaking must not exceed the limits of two out of the following three criteria: a balance sheet total of €350,000, a net turnover of €700,000, and an average employee headcount of 10.[43] A small undertaking must not exceed the limits of two out of the following three criteria: a balance sheet total of €4 million, a net turnover of €8 million, and an average employee headcount of 50.[44] A medium-sized undertaking must not exceed the limits of two out of the following three criteria: a balance sheet total of €20 million, a net turnover of €40 million, and an average employee headcount of 250.[45] Meanwhile to qualify as a large undertaking, an undertaking must exceed at least two of the following three criteria: a balance sheet total of €20 million, a net turnover of €40 million, and an average employee headcount of 250.[46] Within the broad limits of these thresholds for SMEs vastly diverse enterprises shelter, from the tiny to the well-resourced.

Clearly SMEs will need to be responsive to consumer preferences around sustainability, whether they are organically demand-led or regulation-led. A competitiveness issue may arise that cannot be ignored without risking business and end user consumers moving to producers and suppliers who are better able to be transparently green and to supply ESG data that regulation and society is demanding.[47] Attitudes and approaches may differ substantially where sustainability reporting is undertaken by SMEs on a voluntary as opposed to mandatory basis. Companies who are purpose-driven with a sustainable value creation model will embrace and commit holistically and responsibly to a transparent reporting landscape. Policies, risk management, measurement against meaningful targets and due diligence are key to this. It is also worth considering that opportunities do exist to create value in line with a low carbon economy and many SMEs already offer green products or services.

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[38] Communication from the Commission, *An SME Strategy for a Sustainable and Digital Europe* Com/2020/103 Final, Introduction.

[39] L Cernat, A Norman-Lopez and A Duch T-Figueras, 'SMEs Are More Important Than You Think! Challenges and Opportunities for EU Exporting SMEs' (September 10, 2014), Chief Economist Notes Series, DG TRADE, Available at SSRN: <http://dx.doi.org/10.2139/ssrn.3777681> accessed 30 June 2023.

[40] Revenue from sale of products and supply of services less any sales taxes or sales rebates that apply.

[41] (n 6).

[42] OJ C 45 E, 23.2.2010, p. 58.

[43] Accounting Directive (n 6) Art 3(1).

[44] Accounting Directive (n 6) Art 3(2).

[45] Accounting Directive, (n 6) Art 3(3).

[46] Accounting Directive (n 6) Art 3(4).

[47] European Commission (n 38) 2.

EU regulatory policy decisions have taken a view of sustainability reporting as being driven largely by larger companies as champions. However, regulatory policy is also being masterfully wielded by EU institutional actors to create trickle-down effects . These impacts are largely unavoidable for SMEs who play an important role in servicing the needs of larger companies without disrupting existing commercial arrangements. The genius of the Directive's stealth approach to value chains (which will be reinforced with the substantive due diligence obligations contemplated by the Corporate Sustainability Due Diligence) is that, over time, knock-on sustainability data requests made to SMEs (both on the single market and in third countries) who have value chain relationships with regulated actors will form the collective glue that delivers real behavioural change. This obliges us to consider specific challenges in relation to sustainability reporting for both listed SMEs who are within the scope of the Corporate Sustainability Reporting Directive and other SMEs who present as a cog in the wheel of a larger entity to which goods or services are supplied. The Impact Assessment for the Directive demonstrated an intention that it would be in lock step with the Corporate Sustainability Due Diligence Proposal, to 'ensure coherence and maximum alignment.'[48] However, inconsistencies in the treatment of SMEs between the two are stark. The inclusion of listed SMEs as regulatory actors mandated to provide sustainability reporting under the Corporate Sustainability Reporting Directive but with the listed SME sector having no direct obligations for SMEs under the Corporate Sustainability Due Diligence Proposal seems anomalous. That said, the knock-on impact on supply and value chain SMEs in relation to both EU measures will be nothing short of staggering.

D. THE WIDENING NET OF SUSTAINABILITY REPORTING AND WHY IT MATTERS FOR SMEs

The Non-Financial Reporting Directive suffered from a scope problem which became in increasingly apparent as the framework matured. The scope was intentionally relatively limited, being designed to start the ball rolling by covering large public interest undertakings with more than 500 employees. In effect this meant that its application was confined to large, listed companies as well as large banks and insurance companies meeting that employee threshold. The Non-Financial Reporting Directive only applied to about 11,000 companies. The base level of entities within the scope of the Non-Financial Reporting Directive is around ,1956 (this excludes exempted subsidiaries) comprising 1,604 listed companies, 278 banks and 74 insurance companies).[49] However, Member States were permitted to extend the reach further during national transposition and this expansion led to 11,500 companies being within scope.[50]

The Corporate Sustainability Reporting Directive's widening net as compared to its legislative predecessor has both direct and indirect and indirect impacts which together will hugely extend the reach of its impact on a vast range of undertakings, and not just those who now must report under it. This means that SMEs should ignore it at their peril. Having got sustainability reporting off the ground with the Non-Financial Reporting Directive, the Corporate Sustainability Reporting Directive manifests the EU's policy desire to considerably expand the scope of entities expected to engage in sustainability reporting.[51] As sustainability reporting under the Directive is rolled out, it is expected to more than quadruple the number of companies reporting as compared with the Non-Financial Reporting

[48] European Commission Staff Working Document, *Impact Assessment on the Proposal for a Directive as regards corporate sustainability reporting* SWD(2021) 150 final Brussels 21.4.2021, 1.2.2.
[49] European Commission, *Study on the Non-Financial Reporting Directive: Final Report* (2020) 8.
[50] ibid. Other entities have chosen to voluntarily comply.
[51] This coheres with the tenor of the public consultation undertaken in connection with the review of the Non-Financial Reporting Directive which showed public support for widening the reporting net in terms of in scope undertakings: European Commission (n 33) 50-62.

Directive to include around 50,000 companies.[52] How is this achieved? First of all, the Corporate Sustainability Reporting Directive widens the net for sustainability reporting beyond 'public interest entities', bringing large companies within scope to include all large undertakings[53] (even where not publicly trading their shares. Second, publicly traded companies[54] including listed SMEs, (but not listed micro-undertakings) will fall within scope due to trading on a regulated market in the EU.[55] An issue of regulatory coherence jumps out when considering the parallel Corporate Sustainability Due Diligence Proposal.[56] The intention was that the Corporate Sustainability Reporting Directive and the Corporate Sustainability Due Diligence Proposal would be closely aligned. However, in practice there are some significant differences. One of these is that no class of SMEs (not even listed SMEs) is included within scope of the Corporate Sustainability Due Diligence Proposal. One may rightly question how this can be rationalised given the professed close inter-relationship envisaged for these two directives with the Corporate Sustainability Reporting Directive providing the reporting framework to the Corporate Sustainability Due Diligence Directive's planned substantive due diligence duties.[57]

The European Union has cut its cloth for now such that for the most part, SMEs will not fall directly within the scope of the sustainability reporting regime. The exception relates to one particular category of SMEs – SMEs (including third country undertakings) that have securities listed on a regulated market in the EU who are within scope alongside large undertakings listed on EU markets. An SME with securities traded on a regulated market of any Member State, will qualify as a 'public interest entity', meeting the public interest rationale for inclusion. The rationale for mandating listed SMEs trading on EU markets to engage in sustainability reporting is to give SMEs equal access to financial markets and investments, bearing in mind the ever increasing demand by investors for sustainability information. That is entirely justifiable. The bigger rationale here in terms of sustainable finance and investing ensures that financial market participants with a sustainability agenda can be inclusive in relation to smaller undertakings by requiring them to disclose relevant sustainability information that the market needs. SMEs make up a significant proportion of listed companies on EU regulated markets and therefore sustainability information is of interest to their investors. Their inclusion within the sustainability reporting net is designed to create a level playing field for them in relation to access to financial markets and capital and to avoid them being treated less favourably by investors who require sustainability information to comply with their own sustainability disclosure requirements laid out in the Sustainable Finance Disclosure Regulation.[58] As discussed below, in recognition of their size, qualifying listed SMEs who are required to engage in sustainability reporting under the Corporate Sustainability Reporting Directive are afforded an accommodation in the form of reporting using simplified reporting standards in order to ease the regulatory burden and are given additional lead-in time as compared to other in scope companies, namely large public interest entities and large EU undertakings and parent undertakings of large groups.[59]By contrast, all non-listed SMEs

[52] This is a European Commission estimate: <https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en#related-links> accessed 30 June 2023.
[53] See further Accounting Directive (n 6), Art 1(4).
[54] The Corporate Sustainability Reporting Directive applies to companies established outside the EU but with subsidiaries listed on an EU-regulated market.
[55] Accounting Directive (n 6), Art1(3), Art 2(1)a (inserted by Art 1(1) of the CSRD (n 5)).
[56] European Commission (n 24).
[57] While falling outside the direct line of regulatory sight, SMEs would nevertheless fall within the peripheral vision of the Proposal for the Corporate Sustainability Due Diligence Directive (n 24) through participation in larger companies' chain of activities.
[58] (n 8). This Is framed In Recital 21 of the Corporate Sustainability Reporting Directive (n 5) as enhancing market access and preventing discrimination by other market participants against smaller undertakings as compared with their larger counterparts.
[59] See further (n 11).

(and micro-undertakings) by virtue of their size are outside direct regulatory scope and thus will have no direct obligation to publishing sustainability disclosures.

Should the Directive have gone further to include disclosure obligations for more SMEs? It has been argued that sustainability should matter for all companies irrespective of whether they are raising capital or not.[60] It has also been cogently argued that it would have been preferable for the Corporate Sustainability Reporting Directive to have expanded its remit to cover either all SMEs, all SMEs above a certain size or all SMEs in designated high impact sectors.[61] Indeed, the European Commission did consider the option of adding non-listed medium sized undertakings into the regulatory mix which would have had a direct regulatory impact upon approximately 160,200 medium-sized undertakings.[62] Ultimately, the European Commission did not proceed with this option. It has been argued that the decision to exclude unlisted SMEs from mandatory sustainability reporting was disappointing given that in certain sectors SMEs are responsible for substantial negative environmental impacts and in some sectors a majority of the relevant economic activity.[63] However, at the time of the Impact Statement, the Commission noted that demand for sustainability information was lower in the case of non-listed medium-sized companies as compared with their larger counterparts and their sustainability impacts were regarded as lower.[64] This may well change. There is the interesting question of whether competitive advantage or disadvantage may result compared to competitors who are not drawn into the net of sustainability reporting under the Corporate Sustainability Reporting Directive. On the one hand, investment in compliance is resource-intensive, particularly in the early years, which may adversely affect the bottom-line; on the other, a company that has transparent green and digital credentials may prove more appealing to the market in the medium to long-term.

It would be a mistake for non-listed SMEs to simply watch from the side-lines as larger players put their house in order. A major consequence of the broad framing of sustainability reporting obligations in the Corporate Sustainability Reporting Directive is that the indirect impact will create ripples that fan out far more broadly than its direct impact on those large and listed entities who are obligated to report under it. Article 19a(2)(f) of the Accounting Directive (as amended)[65] initiates mandatory extended value chain reporting by a company concerning its upstream sourcing of raw materials and downstream use of its products or services to end of life.[66] Data is central to the sustainability reporting model, and it will force suppliers to level up and come on board. This regulatory lever banks upon creating a massive cascade or waterfall effect. The indirect impact flows down from the reporting company right across the upstream and downstream value chain as a whole.[67] The cascade effect is predicated upon the need for actors in the value chain to supply relevant information to the reporting company in order for it to carry out an impact materiality assessment, creating pressure on suppliers to reporters to level up. So, for example, within the garment industry, a large clothing company who is obliged to carry out EU sustainability reporting will need to be asking relevant ESG questions of their suppliers of fabric as raw material irrespective of their size, and of the factories they have chosen to contract with to manufacture the clothing sold by the reporting company. This will assist in creating a

[60] Chiu (n 17) at 107.
[61] M Bossut and others, 'Why it Would be Important to Expand the Scope of the Corporate Sustainability Reporting Directive and Make it Work for SMEs' Sustainable Finance Research Platform Policy Brief 8/2021 <https://wpsf.de/wp-content/uploads/2021/09/WPSF_PolicyBrief_8-2021_Scope.pdf> accessed 30 June 2023.
[62] European Commission (n 48) 6.3.5.
[63] Bossut and others (n 61).
[64] European Commission (n 48) 6.3.5.
[65] Accounting Directive (n 6), Art19a(2)(f) (as substituted by Art 1(4) of the CSRD (n 5)).
[66] This understanding is confirmed by the expansive definition of 'value chain' in European Commission, draft Delegated Regulation as regards sustainability reporting standards: European Sustainability Reporting Standards ESRS 1, *General Requirements* (6 June 2023), <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set_en> accessed 30 June 2023, Annex II, 30.
[67] Notably this is not limited to contract-based business relationships in the value chain and the relationships covered go beyond the first tier of an undertaking's value chain.

flow of sustainability information that will aid decision-making by stakeholders. However, the cascade effect of the Directive creates practical challenges for upstream and downstream parties, particularly SMEs and micro-undertakings.

E. SUSTAINABILITY MATTERS REPORTED ON AND DIRECT AND INDIRECT IMPACTS ON SMEs

This Part considers the nature of sustainability reporting interfaces under the Corporate Sustainability Reporting Directive and implications for listed SMEs and other actors who fall directly within scope and includes a consideration of the ramifications of extended value chain reporting on SME value chain actors.[68] The discussion on direct reporting is of particular relevance to the listed SME sector. However, its ambition and the strategic approach that companies are expected to play in relation to ESG matters and the just transition, as well as the nature of value chain reporting should be carefully considered by the boards of SMEs and their advisors in deciding upon their own strategy.

Direct Reporting by In Scope Actors

The Non-Financial Reporting Directive required information to be reported in the annual report, but individual Member States could permit publication as a separate document. The Corporate Sustainability Reporting Directive indicates that the appropriate place for mandatory sustainability reporting is in a clearly identifiable part of the management report,[69] most likely to be termed the sustainability report. This means that sustainability reporting will need to be labelled as such and that there is less chance of burying the 'information necessary to understand how sustainability matters affect the undertaking's development, performance and position'.[70] It is also expected to be publicly available on the company's website. The Corporate Sustainability Reporting Directive's double materiality perspective overtly expands the Non-Financial Reporting Directive's approach in i looking inward at its impacts on the company and its performance and outward at its impacts (both positive and negative) on the wider world.[71] Companies and their advisors are adjusting to this changing landscape.[72]

In terms of progression from the Non-Financial Reporting Directive, the ESG areas that need to be covered in sustainability reporting are much more finely detailed. There is a clear setting out of environmental factors, social factors[73] and governance factors[74] including some sub-topics within ESG areas for reporting on. To ensure coherence with other developments, these are based on how sustainability factors are defined in the Sustainable Finance Disclosure Regulation,[75] but with the addition of governance matters. While the Non-Financial Reporting Directive had included broadbrush references to environmental matters as constituting part of the expected non-financial reporting

[68] More particularised aspects of reporting and standards are dealt with in subsequent Parts.
[69] Accounting Directive (n 6), Art 19a(1) (as substituted by the Art 1(4) of the CSRD (n 5).
[70] Ibid.
[71] The double materiality perspective covers financial, environmental, social and governance angles and it is entirely possible though not required for matters, for example, for environmentally material matters to also assume financial materiality. See further J Baumueller and K Sopp, 'Double Materiality and the Shift from Non-Financial to European Sustainability Reporting: Review, Outlook and Implications' (2022) 23(1) 8 <https://doi.org/10.1108/JAAR-04-2021-0114> accessed 30 June 2023.
[72] T De Cristofaro and C Gulluscio, 'In Search of Double Materiality in Non-Financial Reports: First Empirical Evidence' (2023) 15(2) Sustainability 15 < https://doi.org/10.3390/su15020924> accessed 30 June 2023.
[73] Social issues have been coming strongly to the fore in divestments by companies of assets in connection with the Russian invasion of Ukraine. For example, Shell made the decision to cease to purchase Russian oil and pull its service stations from Russia while BP announced a $25 billion writedown asociated with divesting its stake in Rosneft, the Russian energy company.
[74] By contrast, governance factors were not evident in the Non-Financial Reporting Directive (n 1).
[75] (n 8).

regime,[76] the Corporate Sustainability Reporting Directive delves deeper to cover a wide ranges of isses from combating climate change, to climate protection, pollution, biosdiversity and circular economy objectives.

One of the perceived shortcomings of the Non-Financial Reporting Directive was that it did not specify whether the reporting approach should be backward-looking or forward-looking and this led to less of a focus on future planning. The Corporate Sustainability Reporting Directive objective is that companies will disclose a dynamic, forward-looking strategy not just a backward-looking focus on compliance performance. So for example, it is necessary to describe how resilient the company's business model and strategy is to sustainability risks including physical and transition risks (and any sustainability dependencies) and how it is planning its sustainable transition.[77] Companies must take steps to ensure that their business model and strategy are compatible with the green transition and with the limiting of global warming to 1.5 degrees in line with the Paris Agreement[78] so as to protect against the occurrence of extreme weather events and the ambitious EU commitment to attaining carbon neutrality by 2050.[79] The Corporate Sustainability Reporting Directive underpins the need for finances to flow in a manner that pays attention to pathways towards climate neutrality and climate resilience. Companies are being expected to set sustainability targets e.g. on reducing greenhouse gas emissions and to report against them.[80]

Value Chain Reporting and Trickle-Down Effects

The EU has demonstrated global leadership with the Corporate Sustainability Reporting Directive's, not just through the mandatory requirement to report on sustainability due diligence processes,[81] but also through its radical inclusion of value chain reporting as key component of sustainability reporting, its reach offers a major push towards global value chain governance and accountability for large companies. [82] Large in scope companies must describe the principal risks or potential risks connected not only with the company's own operations, but with 'its value chain, including its products and services, its business relationships and its supply chain' including how it monitors these impacts as part of any requirement to conduct a due diligence process.[83] This will encompass describing the principal actual or potential impacts, not just in the company's own operations, but right across its entire upstream and downstream value chain. Large reporting companies will therefore need to capture and review how other partners in their value chain (including SMEs) impact on achievement of the company's sustainability strategy. Therefore these matters need to also be taken seriously by value chain SMEs and appropriate lines of communication opened.

Scope 3 emissions provide an example of an intractable challenge presented for SME value chain actors. Reducing carbon impact is front and centre in the Corporate Sustainability Reporting Directive with the Directive forcing attention on Scope 3 emissions in the context of climate-related disclosures. Scope 3 emissions have particular relevance in an SME value chain actor context since they cover indirect emissions that occur in a company's upstream and downstream value chain and form part of value chain sustainability reporting. This means that value chain actors must unlock the relevant

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[76] Accounting Directive (n 6), Art 19a(1) (as inserted by Art(1) of the NFRD (n 1)).
[77] Accounting Directive (n 6), Art 19a(2)(a) (as substituted by Art 1(4) of the CSRD (n 5)).
[78] Paris Agreement (n 19).
[79] As established in Regulation (EU) 2021/1119/EU of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law').
[80] Accounting Directive (n 6), Article 19a(2)(b) (as substituted by Art 1(4) of the CSRD (n 5)).
[81] Accounting Directive (n 6), Art19a2(f)(i) (as substituted by Art 1(4) of the CSRD (n 5)). This will work alongside the creation of substantive due diligence duties in the proposed Corporate Sustainability Due Diligence Directive (n 24).
[82] A company's value chain outside the European Union within third countries is also within scope: see the discussion in Recital 33 of the Corporate Sustainability Reporting Directive.
[83] Accounting Directive (n 6), Art 19a(2)(f)(ii) (as substituted by Art 1(4) of the CSRD (n 5)).

emissions data. If larger actors help to hold SMEs to account behavioural change around decarbonising will happen quicker. Collaboration and lending of resources by larger entities would be hugely beneficial to the SME sector. In time we are likely to see supplier codes of conduct and standards around greenhouse gas emissions. However, there has been a corporate backlash against having to engage in Scope 3 carbon reporting from a company's suppliers and its clients in part because getting detailed data is very difficult including where suppliers are small enterprises in developing countries.[84]

There is an understanding that companies may have considerable difficulty in getting all the information that they need in relation to their value chain to report on actual or potential key adverse sustainability impacts, so the Corporate Sustainability Reporting Directive builds in an understanding that this can be explained during the first three years of reporting. There is some leeway on value chain reporting for the first three years in acknowledgment that it might not prove possible for a company to get all the necessary information about its value chain.[85] Notably, the draft European Reporting Standards also expressly acknowledge that it could be challenging for large companies to obtain value chain information from SMEs and other entities in their value chain that do not have direct reporting obligations under the Directive.[86] The Commission's draft text incorporates EFRAG's suggestion that in certain cases it may be expedient to simply provide broad sector estimates as a proxy in relation to the undertaking's upstream and downstream value chain.[87] This illustrates the possibility of a chasm between ambition and reality in the context of value chain reporting, something that has led the European Commission to suggest further dilution of timelines and obligations in its consultation on the reporting standards.[88] Indeed, pragmatically the Commission took the opportunity in June 2023 to formally state that it 'encourages large corporates and financial intermediaries to apply the principle of proportionality when engaging with SMEs and to exercise restraint when requesting information from SME value chain partners.[89]

This may allow the SME sector some respite while getting their house in order to capture and analyse relevant data. There is a marker set down in the European Commission's draft ESRS, that from year 4 (when it is no longer possible to limit information on impacts in the company's upstream or downstream value chain) the information that in scope undertakings are expected to report on in relation to the SMEs in their value chain, 'will not exceed' what will be expected of listed SMEs under their lesser reporting obligations in the yet to be drafted ESRS standard for listed SMEs.[90] There will be real challenges in tracking supply chains and measuring impacts. Although reporting is once a year, in practice dialogue with industry partners and suppliers will need to be ongoing. Furthermore, capturing and managing data will be crucial. Technology can assist.[91]

More broadly, behavioural adjustments in the SME sphere are the likely to result from regulatory trickle-down as regulatory drivers upstream or downstream influence market behaviour. Apart from reporting, analysis of data gathered may lead to changes in procurement behaviour in the short, medium and long-term given the associated requirement to report on actions to prevent and mitigate

[84] G Tett, S Mundy and A Jack, 'The Key Debates at WEF 2023' *Financial Times* (23 January 2023) <https://www.ft.com/content/8afc3516-8162-4b75-8793-4dd66b7c2336> accessed 30 June 2023.
[85] Accounting Directive (n 6), Art 19a(3) (as substituted by Art 1(4) of the CSRD (n 5)).
[86] EFRAG, *Draft European Sustainability Reporting Standards ESRS 1: General Requirements* (23 November 2022), para 74.
[87] ibid para 73; European Commission, draft Delegated Regulation as regards sustainability reporting standards (n 66), Annex I, European Sustainability Reporting Standards ESRS 1, *General Requirements* para 68-72.
[88] European Commission, draft Delegated Regulation as regards sustainability reporting standards (n 66).
[89] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Sustainable Finance Framework that Works on the Ground* COM/2023/317 final 13.6.2023.
[90] European Commission, draft Delegated Regulation as regards sustainability reporting standards (n 66), Annex I, European Sustainability Reporting Standards ESRS 1, *General Requirements* para 134. This message is reinforced in European Commission (n 89).
[91] Digital twinning and distributed ledger technologies are particularly useful.

harm. In effect we are seeing large actors becoming stewards of their value chain which make shake up path dependencies in the supply chain. Although there will be instances where a company will justifiably have to report on its unavoidable dependency associated with a sustainability risk, market adaptations will inevitably mean that trickle-down effects will begin to occur whereby SMEs begin to adjust their market behaviour so as to be competitively attractive even though they are not mandated to do so. It is not difficult to imagine that SMEs may experience moral suasion in the form of market pressure to follow best practice voluntarily.

F. THE ADVENT OF EUROPEAN SUSTAINABILITY REPORTING STANDARDS

Mandatory EU sustainability reporting standards are a key deliverable envisaged by the Corporate Sustainability Reporting Directive. The Non-Financial Reporting Directive's *laissez-faire* approach, allowing party autonomy in relation to choice of reporting frameworks led to fragmentation in how reporting was approached.[92] Companies could choose to rely on national, European or international reporting frameworks at their discretion, something which does not make for usability for third party users of disclosures where comparability as well as reliability are key tenets. Sustainability information disclosed was often not user-friendly; it could be vague, buried in information overload, making impression management and greenwashing entirely possible. This made it challenging for stakeholders who wanted clear and comparable data. The European Commission's publication of non-binding guidelines on reporting under the Non-Financial Reporting Directive [93] (rather than standards) was not viewed as having had the desired effect on improving disclosures.[94] Consequently, at the heart of the Corporate Sustainability Reporting Directive is the objective of delivering on mandatory common reporting standards with sufficient granularity to address the significant deficit of the Non-Financial Reporting Directive regime that led to perceived 'challenges regarding comparability, reliability and relevance of information.'[95] A policy decision was made that the European Union needs to be at the vanguard of standard setting rather than simply leaving this to other actors at national and supranational level.[96] The need for EU sustainability reporting standards is also underscored by the increasing demand for sustainability information from asset managers, financial advisors, lenders and other stakeholders. The standards area is a crowded space and there is no denying that transnational approaches would be valuable in the long run.[97] However, this remans a bigger fish to fry.

As the level of principle, Article 29b(2) of the new Chapter 6b on the European Sustainability Reporting Standards[98] indicates that t the information reported must be 'understandable, relevant, verifiable, comparable' and accurate. Work on the European Sustainability Reporting Standards ('ESRS') has drawn on existing international standards and EU work on the Sustainable Finance Disclosure Regulation[99] and Taxonomy Regulation[100] with view to ensuring consistency. The ESRS will provide

[92] Ahern (n 16) 602.
[93] European Commission, Communication from the Commission: *Guidelines on Non-Financial Reporting (methodology for reporting non-financial information*) C/2017/4234 OJ C215, 5.7.2017, p 1; European Commission, Communication from the Commission: *Guidelines on Non-Financial Reporting: Supplement on reporting climate-related information* C/2019/4490 OJ C209, 20.6.2019, p 1. The climate reporting guidelines sought to reflect the recommendations of the Task Force on Climate-related Financial Disclosures: Task Force on Climate-related Financial Disclosures, *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures* (2017).
[94] European Commission (n 51) 28.
[95] ibid.
[96] A popular reporting framework is the Global Reporting Initiative (GRI), *The Global Standards for Sustainability Reporting* (2022) <https://www.globalreporting.org/standards/> accessed 30 June 2023.
[97] See, for example, the work of the Task Force on Climate-related Financial Disclosures, the Global Sustainability Standards Board and the International Integrated Reporting Council. On the profusion of different reporting standards see G Tsagas and C Villiers, 'Why "Less is More" in Non-Financial Reporting Initiatives: Concrete Steps Towards Supporting Sustainability' (2020) 10(2) Accounting, Economics, and Law: A Convivium 20180045 <https://doi.org/10.1515/ael-2018-0045>.
[98] Accounting Directive (n 6), Art 19a(1) (as substituted by Art 1(9) of the CSRD (n 5)).
[99] (n 9).
[100] (n 8).

detailed, prescriptive guidance in relation to the disclosure that companies must make under the Corporate Sustainability Reporting Directive E including on environmental matters such as climate change, biodiversity and ecosystems, use of resources and the circular economy. They will also cover disclosure of scope 1, scope 2 and scope 3 emissions. In short, the ESRS will assist companies with the finer details of preparing reporting. Following drafting work by EFRAG (previously known as the 'European Financial Reporting Advisory Group') in consultation with stakeholders on draft European sustainability reporting standards dealing with general requirements (ESRS 1),[101] and a public consultation by the European Commission on its revised text of a draft delegated Act,[102] the European Commission is expected to adopt the first set of general (sector agnostic) ESRS applicable to all sectors in 2023.[103] This will take the form of cross-cutting standards for the disclosure of ESG matters. The Corporate Sustainability Reporting Directive's implementation timelines are tight and even given the phasing in of reporting are ambitious given the need to allow business time to respond meaningfully and to implement the necessary systems to capture and analyse data as well as strategy setting for the yet to be finalised standards. Reflecting this, the Commission took the opportunity in its June 2023 public consultation on the general ESRS to propose additional phasing in of aspects of sustainability reporting which would assist all companies, and in particular smaller companies that are directly subject to sustainability reporting requirements for the first time, to adjust and prepare.[104]

Seemingly influenced by international developments, somewhat controversially, the Commission's version of the draft standards saw the Commission giving companied far more freedom to omit information including on climate unlike the mandatory approach taken by EFRAG. The draft sector-agnostic ESRS[105] show that the Commission has been willing to make certain concessions in relation to when aspects will become operational by phasing in some requirements.[106] This will be of particular benefit to smaller companies. Thus, for example, companies with less than 750 employees can omit Scope 3 GHG emissions reporting and those related to value chain workers for the first two years of their reporting. Other environmental issues can be omitted for one year. More controversially, the Commission is proposing that companies be given the freedom to self-determine without providing an explanation what is considered 'material' for the purposes of sustainability double materiality.[107] This would represent a significant volte face in ambition concerning the realisation of the sustainable finance agenda. However, the fact that this is being consulted on, perhaps speaks more than anything to the complex, expensive and protracted minefield that putting in place the systems for sustainability reporting entails, and to an awareness of the wider international policy climate around sustainability reporting.[108]

Further sector-specific standards must be adopted by 30 June 2024, and it is within this work programme that we can expect to see standards for listed SMEs being published. EFRAG's Community Working Group for Listed SMEs' Standards is developing scaled-down technical standards for listed

[101] EFRAG (n 86).

[102] The European Commission revised draft of EFRAG's draft of the reporting standards was published on 6 June 2023 as a draft Delegated Act (n 66) for consultation. The draft standards comprise 12 draft standards on ESG matters consisting of 2 general standards, 5 environmental standards, 4 standards on social matters and 1 standard on governance.

[103] The Commission will reflect on feedback received from its public consultation in mid-2023 to finalise the text of the standards.

[104] European Commission draft Delegated Regulation as regards sustainability reporting standards (n 66).

[105] ibid.

[106] ibid 5.

[107] European Commission draft Delegated Regulation as regards sustainability reporting standards (n 66), Annex I, European Sustainability Reporting Standards ESRS 1, *General Requirements*.

[108] The International Sustainability Standards Board is expected to publish its general requirements standard (IFRS S1) and its climate-related disclosure standards (IFRS S2) in 2023 with a potential effective date of reporting periods from 1 January 2024. These will also have a knock-on effect on small companies in the supply chain of larger in-scope companies. However, the focus is different, being on internal financial risk rather than adopting a broader double materiality perspective. It seems that this may also be the approach that will ultimately be adopted by the United States Securities and Exchange Commission to climate disclosures.

SMEs in relation to their sustainability reporting for submission to the European Commission. Furthermore, as discussed in Part G below, voluntary standards for SMEs who do not fall within scope are also being developed by EFRAG to assist them given their significant role in the value chain.

G. SME REPORTING

The European Sustainability Reporting Standards will guide undertakings in relation to the type of information that they will need to seek from their suppliers and value chain. This will in turn have trickle-down effects on those in their supply and value chain including SMES who will need to supply that information. Reporting will help to mainstream sustainability policies and disclosures. On the other hand, real hurdles may be experienced in gathering information from smaller suppliers in the value chain. There are real implications in terms of time and cost for SMEs who find themselves within the supply chain or value chain of a large company within the scope of the Corporate Sustainability Reporting Directive. Therefore a proportionate approach to the development of EU sustainability reporting standards is vital. The discussion which follows examines the implications of listed SME reporting standards and the development of voluntary sustainability reporting standards for other SMEs who are not obliged to report.

Listed SME Reporting

Listed SMEs will be expected to comply with special-scaled down reporting standards. The Commission has given the cue that these standards will be proportionate and focus on 'the financing-relevant information needed by financial institutions'.[109] Although listed SMEs' economic activity and environmental impact are significant, there is a recognition that it will be more challenging for SMEs to comply not least due to their more limited resources. It is important that they be given sufficient time to adapt to the arrival of sustainability reporting. This led to a number of concessions being given to listed SMEs in relation to when the reporting obligation would kick in. First, additional lead-in time until 2026 is afforded them as compared to other in scope undertakings (namely large public interest entities and large EU undertakings and parent undertakings of large groups). Secondly, under Article 19a(7) during a transitional two year period from 2026, listed SMEs can choose to opt out of sustainability reporting entirely for financial years commencing before 1 January 2028.[110]

Reflecting the outcome of the Commission's stakeholder consultation, listed SMEs that are within scope will be able to report using simplified standards.[111] It is to be hoped that simplified reporting will alleviate some of the not insignificant burden associated with reporting. The reporting expectations of listed SMEs are vastly truncated as compared with larger entities reporting under the Corporate Sustainability Reporting Directive. Listed SMEs have a derogation in Article 19a(6)[112] that permits them to have a limited sustainability reporting regime of far less detail and breadth than that which applies to other undertakings.[113] Articles 19a(6)[114] and 29c[115] establish this simplified SME sustainability reporting for listed SMEs. The main reporting responsibility is to provide a brief description of their business model and strategy and a description of the company' sustainability policies.[116] They also must detail 'the principal actual or potential adverse impacts of the undertaking on sustainability matters' and 'any actions taken to identify, monitor, prevent, mitigate or remediate

[109] European Commission (n 89).
[110] In this case a brief justification must be provided in the management report for why sustainability reporting was not provided.
[111] Public consultation undertaken in connection with the review of the Non-Financial Reporting Directive showed 74 percent of respondents supported having simplified reporting for SMEs: European Commission (n 33) 4.8.
[112] Accounting Directive (n 6), Art 19a(6) (as substituted by Art 1(4) of the CSRD (n 5)).
[113] This carve-out is also provided to small and non-complex financial institutions (essentially, smaller banks) and captive insurance undertakings and captive reinsurance undertakings.
[114] Accounting Directive (n 6), Art 19a(6) (as substituted by Art 1(4) of the CSRD (n 5)).
[115] Accounting Directive (n 6), Art 29c (as inserted by Art 1(8) of the CSRD (n 5)).
[116] Accounting Directive (n 6), Art 19a(6)(a) and (b) (as substituted by Art 1(4) of the CSRD (n 5)).

such actual or potential adverse impacts.'[117] In terms of risks, information must be provided on 'the principal risks to the undertaking related to sustainability matters and how the undertaking manages those risks.'[118] Furthermore, Article 19a(6) specifies that information must be provided on key indicators applicable to these disclosures. Indirect value chain due diligence reporting is noticeably absent for listed SMEs, considerably reducing the compliance burden.

By contrast, much fuller information is requested for other public interest undertakings in this context including as regards, the resilience of the business model and strategy as regards sustainability risks, the sustainability opportunities presented for the undertaking, details of the plans including financial and investment plans to meet the Paris Agreement limiting global warming to 1.5 degrees and net zero 2050 objective. They are also required to provide targets and timeframes in this regard and to report progress against them. Tying in with the aspirations of the CSDD, other public interest entities must also provide a description of principal actual or potential adverse impacts in their own operations, and within their value chain, their business relationships and supply chain and their sustainability due diligence processes and to report on actions taken 'to prevent, mitigate, remediate or bring an end to actual or potential adverse impacts'.[119]

The objective of bringing listed SMEs within the net is to enable listed SMEs to report information that would be of meaningful to financial institutions and investors in the transition to sustainable finance and investing. Obviously the watered down reporting expectations of listed SMEs represent the outcome of a political balancing act in terms of agreeing what was proportionate for SMEs. The adequacy of their reporting requirements will be a matter for reflecting upon down the line once sustainability reporting has bedded down, potentially enabling the level of ambition in terms of scope to be scaled up.

Much rests on the publication by the Commission of draft standards for SMEs listed on a regulated market in the EU. Currently EFRAG's Community Working Group for Listed SMEs' Standards is developing a draft for delivery to the Commission (the 'draft LSME ESRS').[120] Unlike the case for larger undertakings within the scope of the Corporate Sustainability Reporting Directive who may also be subject to sectoral standards as well as the general standard, listed SMEs will simply have one composite reporting standard to get to grips with. The tall order for this process is to deliver reporting standards for SMEs that are proportionate for the context and do not impose an undue burden. In the meantime we can speculate about what to expect.

Drafting work on listed SME reporting has begun with the text of the ESRS General Requirements and added a proportionality lens.[121] EFRAG defines proportionality in terms of 'the relation between the sustainability report's scope and complexity compared to the undertaking's resources and know-how.'[122] However, there are large differences of approach needed between reporting standards required for listed SMEs and larger actors given that the Corporate Sustainability Reporting Directive's watered down approach to disclosures for listed SMEs focuses on qualitative statements over quantitative inputs and is not value chain focused. While there is broad equivalence in overall reporting areas, the Directive expressly lays out a more limited menu for listed SME in terms of detailed disclosures as compared with their larger cousins, leading EFRAG to wonder if that precluded

[117] Accounting Directive (n 6), Art 19a(6)(c) (as substituted by Art 1(4) of the CSRD (n 5)).
[118] Accounting Directive (n 6), Art 19a(6)(d)(as substituted by Art 1(4) of the CSRD (n 5)).
[119] Accounting Directive (n 6), Art 19a(2)(f)(iii) (as substituted by Art 1(4) of the CSRD (n 5)).
[120] EFRAG has consulted with those falling within its remit as well as other stakeholders such as accountants who may be involved in the preparation of such reports and banks and value chain partners who may be interested in engaging with such reports.
[121] A decision was made by EFRAG to hive off specific requirements applicable to the classes other than listed SMEs to a sector-specific layer of standards to be subsequently drafted: EFRAG (n 123) 3.
[122] ibid 4.

the addition of wider scope items.[123] Presumably it does. Of course listed SMEs may also voluntarily choose a values-driven approach which goes beyond a minimum compliance approach to engaging with and reporting on environmental and human rights matters. A further question arises as to whether the Commission may decide to further dilute what is required of SMEs or impose additional phase-in time before adopting the LSME ESRS.[124]

Voluntary Reporting Standards for Non-Listed SMEs

It is a matter of considerable significance that many SMEs who are not within the scope of the undertakings required to engage in sustainability reporting under the Corporate Sustainability Reporting Directive will nonetheless inexorably be drawn into its web as suppliers of goods and services to undertakings within the reporting regime. Thus they will need to be prepared to provide relevant and accurate sustainability information. These entities could choose to voluntarily engage in sustainability reporting in respect of their operations based on a values-driven approach to engaging with ESG matters and reporting on them. Such a mindset would accordingly voluntarily embrace transparent reporting. In any event ,all SMEs should undertake an assessment to determine if and to what extent they fall within the value chain of in scope entities under the Corporate Sustainability Reporting Directive so that they can prepare to collect and provide relevant data. At the very least, a pragmatic, adaptive approach would be sensible for an SME undertaking that lies in the value chain of an undertaking that has reporting obligations under the Corporate Sustainability Reporting Directive. Separately, some SMEs may independently wish to take advantage of planned standards for voluntary reporting SMEs with a view to making a case for gaining access to sustainable or transition finance to assist in their green transition.

Reflecting the large elephant in the room which is the 'trickle-down' effect of the Corporate Sustainability Reporting Directive on SME value chain actors, the European Commission proposed developing proportionate separate standards that non-listed SMEs could voluntarily use to engage with ESG matters.[125] Voluntary sustainability reporting standards will allow the SME sector to have a framework for providing needed disclosure to stakeholders and also allow them to engage in strategically monitoring and managing their sustainability journey as part of a wider transition to a low carbon economy. It will also leverage their ability to access sustainable finance. Accordingly, EFRAG is working to develop proportionate and simplified voluntary sustainability reporting standards ('VSRS SME') for SMEs that are not within the scope of the Corporate Sustainability Reporting Directive.[126] EFRAG's work on the draft VSRS SME used the reporting standards for listed SMEs as a base and the understanding is that information that goes beyond what is expected in the LSME reporting standards should not be expected of SMEs in a value chain. That provides a useful backstop.

Under the draft VSRS, SMEs provide 'a statement about the relevance of the business operations related to positive and negative effects on people, the environment and the financial performance. The statement also describes the strategy to pursue its commitment to reach its goals.'[127] SMEs are also expected to disclose whether they have a sustainability strategy and if so targets set and progress achieved against targets set. They would also be expected to provide an overview of the businesses in the value chain e.g. their suppliers, sellers and distributors. The ramping up of trickle-down ambition

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[123] EFRAG, *Approach to the Development of European Sustainability Reporting Standards for Listed SMEs – Issue Paper* (2022) <Issues Paper> accessed 30 June 2023.

[124] In this regard, it is instructive that on 6 June 2023 the Commission launched a public consultation that included additional carve-outs in the sector-agnostic standards in June 2023: European Commission (n 66).

[125] The desirability of doing so was identified by the Commission in the Corporate Sustainability Reporting Directive's Impact Assessment: European Commission (n 62) 5.2.1*,* Option 1.

[126] See EFRAG, *Draft Sustainability Reporting Standards (SVRS) for Small and Medium Sized Enterprises (SMEs)* EFRAG (21 July 2022) ('draft VSRS') in EFRAG, *EU Voluntary Sustainability Reporting Standard for Non-Listed SMEs that are outside the scope of the Corporate Sustainability Reporting Directive – Issue Paper* (2022) <Non-listed SMEs Issues Paper> accessed 30 June 2023, Appendix I, 2.

[127] ibid para 18.

is evident in Disclosure Principle 13 of the draft VSRS which asks voluntarily reporting SMES to disclose whether their suppliers are also using voluntary sustainability standards.

While the draft ESRS for listed SMEs include disclosure requirements deriving from the Sustainable Finance Disclosure Regulation and the Taxonomy Regulation, with an eye to proportionate burden, these are omitted from the draft VSRS SME. Likewise, the draft VSRS SME do not add a further layer related to sector-specific requirements. Furthermore, reflecting the breadth of the SME landscape, digitisation of relevant voluntary disclosures is wisely presented as optional for non-listed SMEs who choose to report. This makes sense given that relevant industries represented would range from agriculture to manufacturing to technology to transport and moreover smaller entities in traditional industries may not readily embrace technology.

As the VSRS emerge as a pathway into sustainability reporting for companies that are not directly within the Corporate Sustainability Reporting Directive, flexibility has to be the name of the game. Crucially, draft general principle 2.a. of the draft VSRS states:

> 'The undertaking is using this Standard on a voluntary basis. The undertaking is expected to complete all disclosures described in the standard or explain which of them are not relevant, significant or available for disclosure by the undertaking. The accessibility of data will override the obligation to report.'

There is an intrinsic understanding that data might not be easy to collect. Thus, for example, if it is not possible for an SME to collect data on scope 3, that can be declared. This type of 'reporting-lite', which is not overly burdensome, is probably essential to encouraging meaningful voluntary take-up in the non-listed SME sector. Nonetheless, EFRAG has been consulting on a number of issues such as whether adopting a 'comply or explain' approach in the draft VSRS SME would potentially undermine the Corporate Sustainability Reporting Directive framework and goals.[128] It remains to be seen how this will play out in the draft VSRS ultimately sent to the Commission and the approach that the Commission will take to what is after all voluntary reporting albeit particularly relevant for SME actors that lie in the value chain of a regulated actor under the Directive.

H. REFLECTIONS ON THE SME CONTEXT

Businesses of all sizes are beginning to recognise that they can play a real in achieving global, regional and national climate targets. Challenges arise nonetheless for EU SMEs in contributing to the green transition and the reduction of carbon footprint. Asymmetries of information are higher while resources are lower in this grouping compared to larger entities. It is well known that the costs of compliance (even where sustainability reporting requirements are diluted and where reporting is voluntary) will often have a disproportionate effect on smaller companies relative to larger ones. As such, new demands for sustainability data and policies may present a barrier to both intra-EU and extra-EU trade. Transformational change is costly and requires considerable set-up costs. It is particularly challenging for SMEs (even those listed SMEs within scope) to develop the necessary frameworks, processes and systems to gather data inputs from across the organisation as a whole and to determine where ownership of the sustainability function will sit within the organisation. This begs the question of how European SMEs can be assisted.

Public support for SMEs on this journey is advocated, as they need to be supported to gain the knowledge and expertise and to take the necessary practical steps to capture relevant data and to compile it in a meaningful fashion. The European Commission rightly sees the green transition and the

[128] ibid.

digital transition as working alongside each other with digitalisation constituting a key enabler to attaining the EU's vision of competitive sustainability amid the transition to a green and circular economy. The Commission's SME strategy for a sustainable and digital Europe is designed to facilitate their transition to both a green and a digital economy.[129] As part of this, the Enterprise Europe Network is expected provide access for SMEs to sustainability advisors. European SMEs have been found to be 'very diverse in terms of business models, size, age, and entrepreneurs' profiles.'[130] That heterogeneity needs to be borne in mind. Some SMEs may be technology related start-ups, au fait with digital technologies and their potential to support sustainability endeavours, others may be traditional and have very little in way of technology or automation in their systems. The problem of technological lag is real: only 17 percent of SMEs have integrated digital technologies (which would assist with reliable data collection and management) as compared with 54 percent of large companies.[131].

With the Non-Financial Reporting Directive, the Commission's vision was that large companies would act as the pioneers of sustainability reporting and would provide support to SMEs down the line through sharing their expertise and experience.[132] This should apply all the more to reporting actors under the Corporate Sustainability Reporting Directive assisting partners in the value chain to prepare by indicating early on what inputs they would like. It is hoped that Member States will also provide sufficient support to SMEs to ensure that the burden on them is not disproportionate. Some Member States are establishing green transition funds to assist companies on the journey towards decarbonisation and energy reduction and also providing practical assistance for SMEs. For example, Ireland has provided a Climate Toolkit that is designed to assist non-listed SME businesses to assess the level of their carbon footprint and environmental impacts with a view to creating a tailored sustainability strategy. Further challenges relate to the preparedness of SMEs located outside the European Union to engage, including those in developing countries.

I. CONCLUSION

The roll-out of European sustainability reporting under the Corporate Sustainability Reporting Directive is an integral part of what has been termed here as the EU's Green Deal and Sustainable Finance Policy Phase. At a micro-level, it will lead to changes in processes and systems; on a larger plane, it may valuably nudge real changes in mindset around sustainability values. In a real sense value chain accountability is upon us and the ripples it will cast will be ever greater. Improving market access to quality, comparable data could encourage a race to the top on the road to decarbonisation. All entities including SMEs have the opportunity to be part of the virtuous circle whether they have direct reporting obligations under the Directive or not. The unique regulatory lens of the Corporate Sustainability Reporting Directive challenges affected companies, not just to mechanically report on, but to qualitatively consider how other partners in their value chain (including SMEs) impact on achievement of the company's sustainability goals. This may motivate behavioural shifts from SME value chain actors anxious to avoid market freeze out due to either information asymmetries or poor sustainability scorecards. Therefore, although the Corporate Sustainability Reporting Directive has not imposed any new reporting requirements on SMEs, except for those with securities listed on regulated markets in the EU, the indirect impact on the SME sector can be expected to be far broader. Many EU SMEs will be flagbearers for the green transition. Others will step up to meet the expectations of

[129] Communication from the Commission, *An SME Strategy for a Sustainable and Digital Europe* COM/2020/103 Final. See also the work of the European Digital SME Alliance <https://www.digitalsme.eu/sustainable-digitalisation/> accessed 30 June 2023.
[130] ibid, Introduction.
[131] ibid 3.
[132] Explanatory Memorandum to Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC as regards disclosure of non-financial and diversity information by certain large companies and groups COM/2013/0207 final (the 'NFRD Proposal').

supply chain partners on matters such as their climate impact. If SMEs fail to step up, they may lose competitive advantage as suppliers of goods and services within the European Union as trade flows become increasingly influenced by sustainability concerns.

The adoption by the European Commission of European Sustainability Reporting Standards standardisation holds the prospect of raising the quality and comparability of disclosures. Credible reporting standards will bring flesh to the bones of the Corporate Sustainability Reporting Directive. A proportionate approach is important. The signal that the information required from value chain SMEs should be no more onerous that under the simplified reporting standards for listed SMEs is important to ensure regulatory coherence, feasibility, and to reduce the administrative burden on regulated actors and SMEs in the value chain.

Looking to the future, an argument that will most likely gather strength over time as part of a deepening sustainability and sustainable finance agenda in the Union is that more SMEs should join listed SMEs within the regulatory net for scaled sustainability reporting. However, for now, a step by step approach to extending the regulatory net is sensible while reporting standards and systems bed down. In the short to medium term, it will be prove interesting to observe how the direct and indirect regulatory influences of EU sustainability reporting under the Corporate Sustainability Reporting Directive ripple out to drive positive change among undertakings of all sizes and sectors.