

Dialogue with standard setters

The adoption of the “EU Taxonomy”: Critical reporting and auditing challenges

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1. Introduction to the “EU Taxonomy”

“Sustainable finance” is about (re-)orientating corporate investments towards environmentally friendly economic activities. Indeed, sustainable finance aims to create value in the long term, directing capital markets towards activities that both generate economic surplus value and benefit society and the environment. Sustainable finance is an essential part of the “European Green Deal” (EC, 2019) that aims to strive for Europe to be the first climate-neutral continent, in the light of the *mantra* that sustainability and the transition to a circular, more resource-efficient and low-carbon economy are vital in ensuring the long-term competitiveness of the European economy. The strategy of the European Union (EU) is about creating a financial system capable of promoting sustainable development from an economic, social, and environmental perspective, implementing the United Nations “Paris Agreement” (UN, 2015a) and the 2030 Agenda for Sustainable Development (UN, 2015b).

In this context, the European Commission published, in March 2018, the “Action Plan: Financing Sustainable Growth” (EC, 2018) and, in July 2021, the “Strategy for Financing the Transition to a Sustainable Economy” (EC, 2021a), based on the 2019 European Green Deal (EC, 2019). To foster its strategy implementation, the EU has put in place a “sustainable financial framework” that relies on three building blocks: 1) a classification system, or “Taxonomy,” of sustainable activities; 2) a disclosure framework for non-financial and financial companies; and 3) investment tools, including benchmarks, standards, and labels.

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Based on the Regulation (EU) 2020/852 (hereafter, also “Taxonomy Regulation”; European Parliament and Council of the European Union, 2020), the first building block of the taxonomy (the “EU Taxonomy” hereafter) establishes a green classification system that translates the EU’s climate and environmental objectives into criteria for specific economic activities. It identifies as green, or “environmentally sustainable,” those economic activities that make a substantial contribution to at least one of the six EU’s climate and environmental objectives while at the same time not significantly harming any of these objectives (“Does not Significant Harm” – DNSH) and meeting minimum social safeguards (“Social Minimum Requirements”). As such, the EU Taxonomy is expected to provide a robust, science-based classification system, allowing non-financial and financial companies to share a common definition of sustainability, thereby protecting against greenwashing (O’Reilly et al., 2023).

The EU Taxonomy can be considered a transparency tool that introduces mandatory disclosure obligations on some companies and investors, requiring them to disclose their percentage of taxonomy-aligned activities/investments (EC, 2023a). It complements the Corporate Sustainability Reporting Directive (CSRD) and requires non-financial and financial companies to respectively disclose the alignment of their activities or investments with the criteria set out in the EU Taxonomy. In particular, under Article 8(1) of the Taxonomy Regulation, large undertakings that are required to publish non-financial information (previously under the Non-Financial Reporting Directive – NFRD, now under CSRD) shall disclose information to the public on how and to what extent their activities are associated with environmentally sustainable economic activities. For the other entities, this disclosure is not mandatory.

In this context, the present paper aims to highlight the critical challenges associated with the reporting and auditing matters arising from applying the EU Taxonomy. A “Questions & Answers” (Q&A) format helps identify and discuss these challenges in light of academic debate and auditors’ practical concerns the authors are participating in or are aware of.

2. Questions & Answers on the critical challenges of EU Taxonomy

Does the EU Taxonomy define rules on business conduct?

No, it does not. The EU Taxonomy is not a mandatory list of economic activities for investors. Nor does it set mandatory environmental

performance requirements for companies or financial products. Investors are free to choose what to invest in, and companies are not required to align with certain green Key Performance Indicators (KPIs; EC, 2021c). Indeed, the EU Taxonomy Regulation only sets mandatory requirements on disclosure to be provided by undertakings. In particular, the EU Taxonomy Regulation requires non-financial companies to disclose:

- The percentage of *turnover* derived from products or services associated with economic activities considered environmentally sustainable;
- The percentage of *capital expenditure* related to activities or processes associated with economic activities considered environmentally sustainable;
- The percentage of *operating expenditure* related to activities or processes associated with economic activities considered environmentally sustainable.

In calculating and disclosing these figures, companies should be aware that Regulation 2021/2178 (Disclosures Delegated Act; EC, 2021b) supplements Article 8 of Regulation (EU) 2020/852, further specifying the content and presentation of these KPIs, as well as the methodology for their measurement and the qualitative information to be included in the reports. Furthermore, in 2023, this regulation was amended by Annex V of Regulation 2023/2486 (EC, 2023b), which provides specific guidance on the KPI reporting models. Non-financial undertakings are therefore required to determine the KPIs, ensuring overall consistency with financial information. Furthermore, their non-financial statement must include references to the balance sheet items relating to these KPIs.

Is this regulation affecting business conduct in any way?

Yes, it is expected that, over time, the EU Taxonomy will enable change and encourage a transition towards sustainability. This is because the EU Taxonomy criteria provide a reference point for companies’ decision-making regarding their green transition. Companies can reliably use the EU Taxonomy to plan their climate and environmental transition and raise finance for this transition if they wish. They can use the EU Taxonomy to improve their overall environmental performance (by either upgrading current activities or starting new activities) and to attract investors. If they wish, financial companies can use the EU Taxonomy to design credible green financial instruments (EC, 2021c).

While aware that this Regulation is four years old, it has gained increasing importance on the agenda of Chief Executive Officers (CEO) in the last few months. This is due to a combination of two critical factors:

- The Taxonomy Regulation provided for phase-in reporting scope exceptions for the first years, but in 2024 and 2025, it will be fully applicable to non-financial and financial undertakings.
- Starting in 2024, the NFRD has been replaced by the CSRD, which significantly expands the number of companies obliged to publish their sustainability reporting (the EU estimates that at the end of the phase-in process, obliged companies will grow from the actual 11,700 to 49,000 across Europe).

These circumstances increase stakeholder expectations for a transparent and fair presentation of the entities' environmental key figures. The complete application of taxonomy alignment disclosure requirements across the industries (financial and non-financial sectors) will lead to a more robust EU Taxonomy-driven interconnection and circularity among the market participants.

Indeed, *non-financial companies* in the CSRD scope will be obliged to disclose to the market whether they have taxonomy-aligned activities and the percentage of their green activities in the total.

At the same time, *investors* can access this information and move their investments toward the greener ones if they are interested in taxonomy-aligned financial assets. This will apply mainly to institutional investors under the scope of the Sustainable Finance Disclosure Regulation (SFDR) (European Parliament and Council of the European Union, 2019), which also have to comply with mandatory disclosures on sustainable investments and are currently active in the promotion of green financial products to their investors since they are increasingly interested in sustainable assets (Garcia-Torea et al., 2024).

Furthermore, *banks* might be incentivized to finance taxonomy-aligned economic activities, e.g., lending, to improve their "Green Asset Ratio." This means that a company applying for a bank loan may get a better interest rate if the loan aims to reach the taxonomy alignment of a given activity or fund taxonomy-aligned activities.

In brief, non-financial companies with taxonomy-aligned activities will benefit from institutional investors, retail investors, and banks interested in green investments, as these latter will be looking to finance taxonomy-aligned economic activities (EC, 2021c).

Are companies' accounting departments ready for EU Taxonomy implementation?

CEOs increasingly see taxonomy reporting and transparency as crucial to their Environmental, Social, and Governance (ESG) goals. Nevertheless, changing regulations and the lack of a global framework and generally

accepted principles for measuring and disclosing environmental performance constitute matters of concern for accounting departments (O’Reilly et al., 2023). In practice, we have witnessed inconsistent interpretations of EU Taxonomy requirements among players in the same sectors. For example, taking into consideration only sectors with a higher degree of business activities homogeneity (such as the financial sector), a study on 2023 Taxonomy KPIs reported by financial institutions across Europe showed significant discrepancies between the same KPIs (KPMG, 2023) (even only for eligibility) indicating that different institutions within the sector use different calculation methods.

The disclosure of methods used was only sometimes transparent, and in particular, the denominators used were calculated differently, frequently leading to non-comparable data. Many institutions have also highlighted the challenges around their counterparts’ taxonomy data availability and quality (PWC, 2023). Similar conclusions could be drawn for other sectors (e.g., airports, telecommunications, technology, consumer services and products). Moreover, only a few market participants have designed and approved internal policies and procedures governing taxonomy reporting, increasing the risk of inaccuracies.

The EU Taxonomy obliges companies to disclose their eligible and aligned KPIs (e.g., turnover, Capital Expenditure – CapEx, and Operating Expenditure – OpEx) and provide qualitative information. The details of the requested qualitative disclosures are specified in the Disclosures Delegated Act (EC, 2021b). For instance, companies should elaborate on their accounting policy on KPIs calculation, explain how the technical screening criteria were assessed, and provide other contextual information relevant to understanding the nature of the KPIs disclosed. Although several Frequently Asked Questions (FAQ) documents published by the EU Commission resolved some of the questions regarding the disclosure requirements, there is still a significant amount of length and quality in companies’ qualitative disclosures (KPMG, 2023). Academic studies confirm that the disclosure of KPIs is adequate, while qualitative disclosure is limited (Hummel & Baernhofer, 2024).

Should we expect a greater integration between financial and sustainability reporting?

Yes, we should. The specific KPIs for which the EU Taxonomy requires disclosure foster a more robust integration between financial and sustainability reporting (Hummel & Baernhofer, 2024). These KPIs connect the

classic financial statement quantities such as turnover, investments and expenditures with sustainability aspects. Indeed, non-financial companies must disclose their share of turnover, investments, and expenditures, which can be classified as green. Determining these shares is not easy; as previously mentioned, companies must develop their internal accounting policies and procedures to ensure data quality. Companies must also obtain robust data from external subjects (e.g., suppliers) to classify their expenditures as green (CapEx and OpEx).

Is this information subject to external audit?

Under Article 34(1) second subparagraph, point (aa) of the Directive 2013/34/EU (hereafter, “Accounting Directive”; European Parliament and Council of the European Union, 2013), any undertaking subject to sustainability reporting under Articles 19a and 29a of the Accounting Directive must obtain an assurance opinion on the sustainability statement (including taxonomy disclosure) presented in their management report. This is important news regarding taxonomy disclosure; since 2024, it has been entirely out of any external assurance or audit scope. We expect the assurance requirement to increase the reporting quality and promote the information’s transparency and comparability (EC, 2024).

Indeed, from the first year of application of sustainability reporting requirements, this assurance opinion must be based on a limited assurance engagement as regards the compliance of the sustainability statement with the following requirements:

- The sustainability reporting requirements provided for in the Accounting Directive (including the compliance of the sustainability reporting with the ESRS adopted under Articles 29b/29c of the Accounting Directive, the process carried out by the undertaking to identify the information reported under those ESRS, and the compliance with the requirement to mark-up sustainability reporting by Article 29d of the Accounting Directive); and,
- The reporting requirements provided for in Article 8 of the Taxonomy Regulation.

Moreover, the Commission is empowered to adopt sustainability assurance standards for reasonable assurance by 1 October 2028, following an assessment to determine if reasonable assurance is feasible for auditors and undertakings.

What is the assurance standard applicable to 2024 reports?

Pending the adoption by the European Commission of assurance standards on this subject matter, based on Article 26(1) second subparagraph of the Audit Directive, Member States may apply national auditing standards, procedures, or requirements as long as the Commission has not adopted an international auditing standard covering the same subject matter.

In order to avoid fragmentation and ensure that practices are as consistent as possible during this transitional period, pending the adoption of Union assurance standards, the European Commission has requested the Committee of European Auditing Oversight Bodies (CEAOB) to develop in 2024 non-binding guidelines for statutory auditors and other assurance services providers.

In the meantime, in Italy, the Ministry of Economy and Finance, supported by the Association of Italian external audit firms (Assirevi), is currently drafting a national transitional assurance standard under the umbrella of the International Standard on Assurance Engagements (ISAE) 3000 Revised (IAASB, 2013) applicable to limited assurance engagements. ISAE 3000 revised requires that auditors plan and perform the engagement to obtain limited assurance about whether the subject matter is free from material misstatement. A limited assurance engagement is less in scope than a reasonable assurance. It provides that the auditor performs procedures like inquiries of management responsible for preparing the subject matter, limited documental analyses, recalculations, and other evidence-gathering procedures, as appropriate. The transitional standard will remain in effect until the International Standard on Sustainability Assurance 5000 (ISSA 5000) comes into force. The International Auditing and Assurance Standards Board approved ISSA 5000 on September 20, 2024, while formal publication is expected in December 2024. At the moment, ISSA 5000 is expected to be applicable from 2025 (for reports published in 2026).

Are there any elements of concern among auditors about these new professional activities?

Presently, one of the main points under discussion is that inconsistent and jeopardized approaches still characterize the degree of responsibility of the auditor in this context. Moreover, the auditors’ duties concerning financial information presented by undertakings in the financial statements and the taxonomy disclosure are unclear.

For example, an item could be immaterial for audit purposes on the financial statements as a whole but also be significant for the limited

assurance on the taxonomy disclosure, with the consequential need to design more profound activities on the latter. Nor is it clear whether and to what extent a possible difference found by the auditor during the audit of financial statements could affect the limited assurance of the Taxonomy Disclosure and vice versa.

This would be a delicate matter, especially when appointing two different statutory auditors to audit the financial statements and ensure the taxonomy disclosure.

Is it possible for an entity to appoint two different statutory auditors to audit the financial statements and the assurance on the Taxonomy Disclosure?

Yes, it is possible. However, the auditor appointed for the assurance on the Taxonomy Disclosure must be the same auditor of the whole sustainability statement. In practice, it seems not probable that entities may choose to appoint two different auditors as it could lead to inefficiencies since both auditors would necessarily perform some understanding and risk assessment procedures.

The Draft Commission Notice released on 7 August 2024 (EC, 2024) cleared a doubt on which one of the two should express the opinion on whether the management report is consistent with the financial statements, specifying that when a statutory auditor or an audit firm other than the one(s) carrying out the statutory audit of financial statements is in charge of expressing the assurance opinion on sustainability reporting, the statutory auditor or audit firm in charge of auditing the financial statements remains in charge of expressing an opinion on the consistency between management report and financial statements for the same financial year.

3. Concluding remarks

In conclusion, adopting and implementing the EU Taxonomy represents a significant step forward in advancing sustainable finance within Europe (EC, 2023a). By providing a standardized classification system for environmentally sustainable activities, the EU Taxonomy aims to promote transparency and prevent greenwashing, guiding companies and investors toward more sustainable practices. However, this transition is not without its challenges (Alessi et al., 2024). The new reporting requirements'

complexity, inconsistent interpretations, and lack of global standards pose significant obstacles for companies and auditors (O’Reilly et al., 2023).

As the complete application of the Taxonomy Regulation and the CSRD comes into effect, companies and auditors must navigate these challenges carefully. Although expected to enhance the quality and comparability of sustainability reporting, the assurance requirements also introduce new responsibilities and potential risks for auditors. Clear guidance and consistent practices will ensure these new requirements lead to meaningful and reliable disclosures.

Overall, the EU Taxonomy serves as both a catalyst for change and a tool for accountability in pursuing a greener economy. Its success will depend on the collective efforts of companies, auditors, and regulators to address the challenges and leverage the opportunities it presents.

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