



Challenges for Japanese Companies Regarding Assurance Opinions Under The Corporate Sustainability Reporting Directive

Kyoko Kozuma*

Professor of Auditing, Kansai University, Japan

Submission: June 28, 2024; **Published:** July 08, 2024

***Corresponding author:** Kyoko Kozuma, Professor of Auditing, Kansai University, Japan, Email: kyoko@kansai-u.ac.jp

Abstract

The CSRD, which entered into force on January 5, 2023, imposes significant disclosure burdens not only on EU companies but on foreign companies operating within the EU regarding sustainability reporting. This paper examines the challenges that arise when Japanese companies seek assurance opinions compliant with the CSRD for their sustainability reporting. These challenges include the substantial room for improvement in Japanese companies' sustainability management to seek CSRD-eligible assurance opinions, the lack of sustainability reporting standards that align with the ESRS, insufficiently established internal control processes regarding sustainability matters within companies, and the risk that Japanese assurance providers may be unable to express CSRD-compliant assurance opinions due to the absence of domestic qualification systems for assurance providers. To address these challenges, some form of policy response will be necessary. However, given the current situations, ultimately Japanese companies will likely need to address these challenges through self-help efforts.

Keywords: CSRD; ESRS; Assurance Engagement; Sustainability Reporting; Japanese Companies

Abbreviations: CSRD: Corporate Sustainability Reporting Directive; EU: European Union (EU); NFRD: Non-Financial Reporting Directive; AD: Accounting Directive; ESRS: European Sustainability Reporting Standards; DD: Due Diligence; HRDD: human rights DD; SDD: Sustainability DD

Introduction

On January 5, 2023, the Corporate Sustainability Reporting Directive (CSRD) [1] entered into force in the European Union (EU). It is an amendment to the Non-Financial Reporting Directive (NFRD) [2], which mandated disclosure of non-financial information by large listed companies and other public-interest entities in the EU. The CSRD expands the scope of the NFRD and introduces more detailed sustainability reporting requirements for undertakings falling under the scope.

While the NFRD applied only to companies established in the EU Member States, the CSRD extends its scope to include third-country undertakings which have a significant activity on the territory of the EU. As a result, approximately 790 Japanese large companies are now compelled to comply with the CSRD [3]. These companies shall publish the sustainability reporting drawn up in accordance with requirements laid down in the CSRD, together with the assurance opinion on the sustainability reporting, by the statutory deadline.

This paper focuses on the assurance opinion mandated by the CSRD and discusses some challenges that Japanese companies might face when complying with the CSRD.

The Cases where Japanese Companies are Required to Comply with the CSRD

Japanese companies fall under the scope of the CSRD in the following cases: (1) through (3).

(1) Their EU subsidiary is subject to the CSRD

i. If a Japanese company owns a subsidiary in the EU that qualifies as a large company (regardless of listing status) or a medium-sized listed company, the CSRD applies to the subsidiary. The EU subsidiary must include its sustainability reporting in the management report and publish it in the EU member State where it was established, along with an assurance opinion.

ii. Additionally, if the EU subsidiary is a parent of a large group, it must comply with CSRD requirements by publishing

consolidated sustainability reporting and the assurance opinion.

iii. These cases apply directly to subsidiaries in EU member states. If subsidiaries meet their CSRD obligations, the Japanese parent company generally isn't required to publish sustainability reporting and assurance opinion unless in the case (3).

(2) Their EU subsidiary qualifies as an exempted subsidiary undertaking under the CSRD

i. An EU subsidiary subject to the CSRD that isn't a large listed company can qualify as an "exempted subsidiary undertaking" if it is consolidated in the sustainability reporting of its Japanese parent company and meets all other CSRD legal requirements. In this case, the subsidiary's obligation to publish its own sustainability reporting would be exempted.

ii. However, the exempted subsidiary must publish the consolidated sustainability reporting of its Japanese parent company along with an assurance opinion in the EU.

(3) They have an EU subsidiary or an EU branch and generated a net turnover of more than EUR 150 million in the EU

i. If a Japanese company generated a net turnover exceeding EUR 150 million in the EU over the last two consecutive financial years, and if its EU subsidiary is a large company (regardless of whether it is listed or unlisted) or a medium-sized listed company, or its EU branch (without an EU subsidiary) generated over EUR 40 million net turnover in the previous financial year, the Japanese parent company or head office must publish and make accessible the sustainability report and assurance opinion through the subsidiary or branch.

ii. For group parent companies, the sustainability report and assurance opinion must be consolidated; otherwise, they should be standalone.

Challenges for Japanese companies regarding assurance opinions under the CSRD

Assurance under a Fair Presentation Framework

The undertaking subject to the CSRD must seek an assurance opinion about the compliance of the sustainability reporting with requirements set out in the Accounting Directive (AD) [4] based on a limited assurance engagement. The level of assurance is expected to be enhanced to a reasonable assurance engagement by October 1, 2028.

In the context of sustainability assurance, assurance providers generally express their opinions on whether sustainability reporting is drawn up in accordance with the sustainability reporting standards, or whether it provides a true and fair view of the company's sustainability performance in accordance with the sustainability reporting standards. The former is the assurance engagement under a compliance framework, while the latter is under a fair presentation framework [5].

However, the CSRD does not explicitly clarify whether the assurance engagement mandated by the CSRD only means the former or whether the latter would be included as well.

According to the auditing provisions of the AD [6], the statutory auditor(s) or audit firm(s) shall express an assurance opinion based on limited assurance engagement regarding the compliance of the sustainability reporting with the requirements of the AD, including:

i. The compliance with the European Sustainability Reporting Standards (ESRS).

ii. The materiality assessment process carried out by the reporting undertaking to identify the information to be reported pursuant to ESRS.

iii. The compliance with the marking up requirements when publishing the sustainability reporting in XHTML format and.

iv. The compliance with the requirements under Article 8 of the EU Taxonomy Regulation [7].

As far as this provision is concerned, the CSRD only requires that the undertaking seeking the assurance opinion carries out the assurance engagement under a compliance framework. However, it does not appear to impose further requirement for the assurance engagement under a fair presentation framework.

Nevertheless, the CSRD aims to achieve a similar level of assurance for financial and sustainability reporting [8]. This intends to eventually mandate a reasonable assurance engagement for sustainability reporting, akin to the audit required for financial statements.

The audit proposition for financial statements involves attesting to "fair presentation" based on a reasonable assurance engagement. Therefore, it is reasonable to consider extending the scope of the assurance engagement for sustainability reporting to include an attestation of fair presentation, if the EU intends to ensure that the level of assurance for sustainability reporting is comparable to that for financial statements.

In this context, there exists an interesting requirement in the ESRS. While the CSRD requires that sustainability reporting must be drawn up in accordance with ESRS [9], the ESRS includes a disclosure requirement for additional information.

This stipulates that a reporting undertaking shall provide additional entity-specific disclosures to enable users to understand the undertaking's sustainability-related impacts, risks or opportunities, when it concludes that an impact, risk or opportunity is not covered or not covered with sufficient granularity by an ESRS but is material due to its specific facts and circumstances [10].

According to the Exposure Draft of the International Standard on Sustainability Assurance 5000 (ED5000), which is developed focusing on the CSRD and its related assurance requirements [11],

the practitioner or assurance provider shall express a reasonable assurance conclusion not only in the case of compliance criteria but also in the case of fair presentation criteria, provided that the sustainability information is prepared, in all material respects, in accordance with the applicable criteria [12]. In the latter case, the applicable criteria must be the fair presentation criteria for sustainability reporting.

The ED5000 defines the term ‘fair presentation criteria’ as a sustainability reporting framework that requires compliance with the framework’s requirements and explicitly or implicitly acknowledges that management may need to provide information beyond what is specifically required or depart from a framework requirement to achieve a fair presentation of sustainability reporting [13]. This definition suggests that the ESRS could serve as fair presentation criteria due to its disclosure requirements for additional information, making it eligible for assurance engagement under a fair presentation framework.

A good example of additional information that the ESRS may request for disclosure could be the sustainability due diligence (DD) process.

While, under the CSRD, the reporting undertaking is required to disclose information on the DD process it has implemented regarding sustainability matter [14], the undertaking is not mandated to conduct the DD process. However, when assessing material negative impacts on people or the environment, the outcome of the undertaking’s sustainability DD process becomes necessary, as it facilitates the recognition of significant impacts, risks or opportunities [15]. In this regard, the ESRS explains that sustainability information about the reporting undertaking should encompass “value chain information”. To achieve this, the undertaking must include material impacts, risks or opportunities associated with its upstream and downstream value chain, following the outcome of its DD process and of materiality assessment [16].

The ESRS does not impose any conduct requirements in relation to DD and does not extend or modify the role of the undertaking’s governance bodies regarding the conduct of DD [17]. However, the ESRS suggests that there are cases where the undertaking should conduct DD process to provide a fair presentation of its sustainability performance.

Recently, the concept of human rights DD (HRDD) has been gaining popularity within Japanese business society. In response to this trend, multiple government ministries jointly published the “Guidelines on Respecting Human Rights in Responsible Supply Chains” in September 2022. These guidelines highlight HRDD as a central corporate action in efforts to respect human rights within supply chains [18].

However, the reality is that Japanese companies are at a primitive stage in terms of implementing HRDD in their operations. According to the “FY 2023 Survey on the International

Operations of Japanese Firms” conducted by JETRO in November and December 2023, less than 10% of respondent companies conducted HRDD during the fiscal year 2023 [19]. Additionally, the “Survey on Efforts Regarding Human Rights in Supply Chains of Japanese Companies,” conducted by the Ministry of Economy, Trade and Industry and the Ministry of Foreign Affairs in September and October 2021, revealed that although 52% of listed companies implemented HRDD, only one out of four companies extended the scope of DD to tier 2 suppliers or beyond. HRDD efforts were mostly limited to the company’s own business activities, with only the company and its domestic subsidiaries included at best [20].

If an undertaking aims to provide a true and fair view on sustainability performance in accordance with the ESRS, whether conducting a limited assurance engagement or reasonable assurance engagement, HRDD must be upgraded to sustainability DD (SDD), encompassing human rights and environmental aspects across the entire value chain. Given the current situation where even HRDD fails to meet the implicit requirements of the ESRS, most Japanese companies subject to the CSRD would find themselves in a difficult situation unless the adoption of SDD rapidly progresses among the businesses in Japan.

Equivalent Sustainability Reporting Standards

As mentioned above, the assurance opinion required under the CSRD includes compliance with ESRS requirements. This is because CSRD-eligible sustainability reporting must adhere to ESRS guidelines.

However, if an EU subsidiary qualifies as an exempted subsidiary undertaking under the CSRD, the consolidated sustainability reporting of its ultimate parent company in Japan, which should be published by the EU subsidiary instead of its own sustainability reporting, may be prepared in accordance with the sustainability reporting standards recognized by the European Commission as equivalent to ESRS.

Moreover, while a Japanese company is required to publish a consolidated sustainability report through its EU subsidiary or branch if it generates a net turnover of more than EUR 150 million in the EU, the report can adhere to one of three reporting standards; ESRS, other sustainability reporting standards recognized by the European Commission as equivalent to ESRS, or sustainability reporting standards for third-country undertakings that the European Commission will adopt by June 30, 2026.

However, currently, there are no high-quality sustainability reporting standards in Japan that the European Commission would recognize as equivalent to ESRS. Most Japanese companies use voluntary sustainability reports as a general means of disclosing sustainability information, and until recently, detailed sustainability information disclosure in annual securities reports of listed companies was not mandatory. Therefore, there has been little impetus for establishing systematic sustainability reporting

standards.

Voluntary sustainability reports in Japan generally follow the Environmental Reporting Guidelines established by the Ministry of the Environment and/or the GRI Standards. However, instead of strictly adhering to these guidelines or standards, Japanese companies commonly base their reports on internally defined criteria referencing these guidelines and standards.

In recent years, the Financial Services Agency has amended Cabinet Office Ordinances to require inclusion of sustainability information in annual securities reports in the TCFD format. However, this requirement is principle-based and does not specify which information to disclose, except for three human capital metrics: the ratio of female employees in management positions, the parental leave uptake rate among male employees, and the gender pay gap.

Furthermore, while Sustainability Standards Board of Japan, Japan's counterpart to the International Sustainability Standards Board, is working to incorporate IFRS S1 and S2 into national standards, there has been no decision by Cabinet Office Ordinance to mandate these as sustainability reporting standards for annual securities reports.

Given this situation, assurance providers in Japan find it impossible to provide the assurance opinion required under the CSRD regarding compliance of sustainability reporting with ESRS or other eligible sustainability reporting standards. Compliance with ESRS poses significant challenges for Japan's disclosure practices, and the reporting standards used by Japanese companies do not meet the quality standards recognized as equivalent to ESRS.

Establishment of Internal Control Processes

To carry out a reasonable assurance engagement, it is essential for companies to have internal control processes related to sustainability matters. In assurance engagements for sustainability reporting, assurance providers must possess a detailed understanding and evaluate internal controls, including the control environment, the entity's risk assessment process, the monitoring process, the information system and communication, and control activities [21]. The entity's risk assessment process involves assessing the significance of risks, including their likelihood of occurrence [22], with DD processes integrated in this case of CSRD compliance. Even with limited assurance engagements, assurance providers need to understand the control environment, the results of the entity's risk assessment process, and the information system and communication [23].

However, many Japanese companies currently lack a solid foundation for gathering basic information on sustainability matters [24]. Unlike financial statements consolidation case, most Japanese companies do not have effective information systems for consolidating sustainability reporting and cannot access

necessary information, especially regarding climate, natural capital, and human capital from their group companies. Hence, there is urgent need to comprehensively develop internal control processes for sustainability matters in anticipation of consolidated sustainability reporting.

Qualification Requirements for Assurance Providers

One more challenge facing Japanese companies seeking assurance opinions on sustainability reporting required under the CSRD is the qualification requirements for assurance providers.

As mentioned earlier, Japanese companies fall under the scope of the CSRD if:

- i. Their EU subsidiaries are subject to the CSRD,
- ii. Their EU subsidiaries qualify as exempted subsidiary undertakings under the CSRD, or
- iii. They have an EU subsidiary or an EU branch and generates a net turnover of more than EUR 150 million in the EU.

For EU subsidiaries subject to the CSRD, there appear to be no specific issues as they publish their own sustainability reporting or consolidated sustainability reporting of their own group, and these assurance opinions are provided by local assurance providers in the EU.

However, if EU subsidiaries become CSRD exempted subsidiary undertakings, such subsidiaries must be consolidated in the consolidated sustainability report of the ultimate parent company in Japan. The consolidated sustainability report and assurance opinion of the ultimate parent company must be published through these EU subsidiaries. Furthermore, the assurance provider expressing these opinions must be an individual or firm authorized under Japanese domestic law to provide assurance for sustainability reporting [25].

Moreover, if the EU subsidiary or branch whose Japanese parent or head office company generates a net turnover of more than EUR 150 million in the EU, the subsidiary or branch must publish the sustainability report and assurance opinion of the Japanese parent or head office company. These documents must be generally and freely accessible. If they are not freely available from the registry in EU Member States, they must be published on the website of the EU subsidiary or branch. In this case, the Japanese assurance provider must be an individual or firm authorized to express an assurance opinion of sustainability reporting under Japanese domestic law or EU member states laws [26].

However, currently, there is no statutory qualification system in Japan for sustainability assurance providers. Therefore, assurance opinions obtained by Japanese companies so far are not eligible under the CSRD, and if this situation persists, future assurance opinions obtained may also be considered illegal under the CSRD.

The Financial Services Agency, as Japan's capital market regulator, established a "Working Group on the Disclosure and Assurance of Sustainability Information" under the Financial System Council from March 2024 to begin discussing system arrangements regarding the assurance of sustainability information. However, specific details, including the establishment of a statutory qualification system for assurance providers, have not been clearly outlined for consideration by 2025.

If the current situation does not improve significantly, there is a high risk of dysfunction in Japan's assurance market, and Japanese companies will have no choice but to contract with European assurance providers to comply with the CSRD. In Japanese society, significant time and costs still seem necessary to meet disclosure and assurance requirements for sustainability reporting that comply with the CSRD.

Conclusion

The purpose of the CSRD is to regulate third-country undertakings that operate extensively within the EU, ensuring they fulfill their accountability for the impact of their business activities on EU society and the environment. Additionally, it aims to level the playing field in business competition between EU companies and third-country companies operating in the internal market. Therefore, within this context, it is not necessarily unjust for certain Japanese companies operating in the EU to bear disclosure obligations under EU law through the CSRD [27].

However, Japan's social systems and corporate reporting practices on sustainability matters are far from EU standards, making it quite challenging to bridge these gaps between the EU and Japan completely. Ultimately, the responsibility to comply with the CSRD lies with individual Japanese companies, which will need to make significant and voluntary efforts and investments to overcome these challenges.

Furthermore, regarding assurance engagements for sustainability reporting, development has largely progressed based on voluntary sustainability reporting, resulting in significant dispersion in the backgrounds and qualifications of assurance providers. Establishing a statutory qualification system for assurance providers, given the current practical situation, may not be straightforward. Individual Japanese companies may find themselves with no choice but to comply with sustainability reporting requirements under the CSRD by separately contracting with CSRD-eligible foreign assurance providers.

References

1. EU (2022) Directive (EU) 2022/2462 of the European Parliament and of the Council.

2. EU (2014) Directive 2014/95/EU of the European Parliament and of the Council.
3. Philipova E (2023) How many companies outside the EU are required to report under its sustainability rules? LSEG Insights.
4. EU (2013) Directive 2013/34/EU of the European Parliament and the Council.
5. IAASB (2023) Proposed International Standard on Sustainability Assurance 5000: Exposure Draft.
6. EU (2013) op.cit.. art.34(1) (aa).
7. EU (2020) Regulation (EU) 2020/852 of the European Parliament and the Council.
8. EU (2022) op.cit., recital 60.
9. *ibid.*, art.29b.
10. European Commission (EC) (2023) Annex1 to the Commission Delegated Regulation of 31.7.2023 (C (2023)5303 final), ERS1(11).
11. International Auditing and Assurance Standards Board (IAASB) (2023a) Explanatory Memorandum for Proposed International Standard on Sustainability Assurance 5000, Section1(14).
12. IAASB (2023b) Proposed International Standard on Sustainability Assurance 5000 (178R).
13. *ibid.*, Definitions (17)(h).
14. EU (2013) op.cit., art.19a (2)(f)(i) & 29a (2)(f)(i).
15. EC (2023) op.cit., ERS1 (45) & (58)
16. *ibid.*, ERS1(63).
17. *ibid.*, ERS1(58).
18. The Inter-Ministerial Committee on Policy Promotion for the Implementation of Japan's National Action Plan on Business and Human Rights (2022) Guidelines on Respecting Human Rights in Responsible Supply Chains.
19. JETRO (2024) FY 2023 Survey on the International Operations of Japanese Firms.
20. Ministry of Economy, Trade and Industry and the Ministry of Foreign Affairs (2021) Survey on Efforts Regarding Human Rights in Supply Chains of Japanese Companies (in Japanese).
21. IAASB (2023b) op.cit., (102R-107R).
22. *ibid.*, (104R)
23. *ibid.*, (102L)
24. Fukushima T (2024) Assurance by a company specializing in sustainability-related assurance engagement (in Japanese), Accounting 76(6): 49.
25. EU (2013) op.cit., art.19a(9)(b) & 29a(8)(b).
26. *ibid.*, art.40a(3).
27. EU (2022) op.cit., recital 60.



This work is licensed under Creative Commons Attribution 4.0 License
DOI: [10.19080/ASM.2024.10.555794](https://doi.org/10.19080/ASM.2024.10.555794)

**Your next submission with Juniper Publishers
will reach you the below assets**

- Quality Editorial service
- Swift Peer Review
- Reprints availability
- E-prints Service
- Manuscript Podcast for convenient understanding
- Global attainment for your research
- Manuscript accessibility in different formats
(Pdf, E-pub, Full Text, Audio)
- Unceasing customer service

Track the below URL for one-step submission
<https://juniperpublishers.com/online-submission.php>