DENTONS GLOBAL ADVISORS

EU Council adopts Corporate Sustainability Reporting Directive

EU strengthens ESG disclosure rules

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The Council of the EU on 28 November rubber-stamped the compromise text on the Corporate Sustainability Reporting Directive (CSRD), marking the final legislative step before the new rules can come into force.

Proposed by the European Commission in April 2021, the CSRD mandates the adoption of EU-wide Sustainability Reporting Standards (ESRS) and strengthens the disclosure rules set out in 2014 in the Non-Financial Reporting Directive (NFRD).

After evidence gathered by the European Commission showed pitfalls in the current EU non-financial reporting framework, the CSRD was put forward to offer a more thorough and meaningful reporting framework that mandates corporate information on Environment, Social and Governance (ESG) issues.

The CSRD constitutes a fundamental piece of the EU's "ESG web" supporting the Green Deal's goal of transforming Europe into the first climate-neutral continent by 2050. It will do so by requiring companies to report on a greater number of ESG indicators according to mandatory reporting standards. Sustainability information must be disclosed in a dedicated section of the management report using a single electronic, machine-readable format.

Scope

The CSRD will apply to all large companies in the EU, whether listed or not, and meeting at least two out of the following three criteria:

> 250 employees; net turnover >EUR 40 million, or; balance sheet total >EUR 20 million.

It will also capture EU subsidiaries of non-EU companies with operations in the Single Market. For those companies, the CSRD may be applicable at the global consolidated level in addition to the subsidiary level.

The CSRD specifies that subsidiaries can be exempted from reporting as long as the parent company reports at consolidated level against standards equivalent to those at EU level. The European Commission shall determine what qualifies as 'equivalent' standards by June 2024.

EU sustainability reporting standards

The CSRD will mandate non-financial disclosures based on European Sustainability Reporting Standards (ESRS). The European Commission shall adopt by 30 June 2023 a delegated act containing the first set of general (i.e. sector-agnostic) reporting standards prepared by the European Financial Reporting Advisory Group (EFRAG). Companies will have to report information on their activities and value chain using ESG indicators in accordance with those mandatory sustainability reporting standards.

EFRAG last week published its revised draft of sector-agnostic ESRS. The Commission will now review this first set and is expected to adopt them via delegated act by June 2023.

EFRAG is expected to release another set of standards dedicated to non-EU companies as well as sector-specific and SME standards by mid-2023, with Commission adoption set for June 2024.

International alignment

While EFRAG collaborates closely with other standard-setting bodies including the International Sustainability Standards Board (ISSB), potential misalignment of emerging ESG disclosure rules around the globe is a major concern for business.

With the CSRD, the EU seeks to be the pacesetter in ambitious ESG disclosure rules by setting new "gold standards" with a strong value chain perspective, including disclosure of Scope 3 greenhouse gas emissions, going beyond emerging international initiatives.

In addition, the principle of double materiality is the key differentiator setting the ESRS apart from other disclosure initiatives including those being developed by the ISSB and the U.S. Securities and Exchange Commission (SEC). Under double materiality, corporates need to disclose their impacts on people and planet (inside-out) as well as on how sustainability issues affect performance, position and development of the business (outside-in).

As the global ESG reporting landscape continues to develop, third country companies with operations in the EU should start preparing for the upcoming CSRD requirements while keeping abreast of the interplay with emerging ISSB and SEC rules on ESG reporting.

What will it take to comply with the CSRD?

- Monitor and report on the business' ESG impacts and risks covering upstream/downstream value chain activities to capture material sustainability matters.
- Report on forward-looking and retrospective information – qualitative and quantitative – across short-, medium-, and long-term time horizons.
- Report on the evolution of activities with regard to these ESG performances as well as the concrete means of implementing this strategy.
- Publish non-financial reports according to the future ESRS, in a dedicated section of the management report, in a digital and machine-readable format.
- Submit reports annually, within 12 months after the start of the financial year on 1 January.
- Audit those ESG reports by an independent structure: first with a so-called limited assurance audit, which will then shift to reasonable assurance at a later stage.

Compliance timeline

The CSRD introduces a phased-in approach to reporting, starting with large public-interest companies that are already in scope of the NFRD. With the CSRD expected to enter into force by year-end, businesses will face the following timeline:

- Large public-interest companies (with over 500 employees) already subject to the NFRD will need to produce their first ESRS-compliant report as of 1 January 2025, covering FY 2024.
- Companies that are not presently subject to the NFRD but which will fall under the CSRD's enlarged scope will be expected to report a year later, i.e. 2026, covering FY 2025.
- Listed SMEs and small and non-complex credit institutions will be subject to reporting according to adapted standards as of 2026, with opt-out possible until 2028.
- Non-EU entities with subsidiaries or branches active in the EU will start reporting in 2029, covering FY 2028.

In case of non-compliance, businesses would face administrative sanctions including financial penalties, which will be left to Member States to define when transposing the directive into national law.

Conclusion: What businesses need to do now

The CSRD sets a global precedent in ESG reporting by putting sustainability disclosures on par with financial reporting. Not only do the new rules broaden the scope of the existing legal framework by including additional environmental aspects, they also mandate reporting on a wide range of environmental, social, and governance indicators along the value chain.

To ensure compliance, businesses should carefully monitor how the CSRD will be transposed nationally in those markets where they have operations. Using a double materiality lens when reviewing the topics covered in the upcoming ESRS is also key to prepare for their application.

Non-EU companies with activities in the EU should closely monitor developments of international and third country standards (ISSB, SEC) and how the EU will determine their equivalence against the ESRS.

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