EU Newsletter Sustainability Reporting

#5 - November 2022

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Two significant events occurred in November:

1) The CSRD has been adopted by the EU Parliament. This will profoundly revise the non-financial reporting requirements under the NFRD (Non-Financial Reporting Directive) from 2025 based on 2024 reporting. This is for companies subject to NFRD and will be later for new joiners such as large non-listed companies, SMEs and non-EU groups. One major point of the CSRD is to impose the standardisation of the sustainability statement.

2) EFRAG has submitted a first set of 12 draft European Sustainability Reporting Standards (ESRS: here) to the European Commission. The drafts will be followed by final standards after adoption by the European Commission, expected in June 2023.

The CSRD is one of the cornerstones of the European Green Deal and the Sustainable Finance Agenda. It is part of a wider EU policy to commit companies to respect human rights and reduce their impact on the planet.

There is no more debate on the regulation to apply to European preparers. The European Regulation (CSRD, ESRS) will apply to them as well as to non-EU stakeholders meeting certain criteria.

Enjoy your reading.

Summary

CSRD ESRS

What is the CSRD and why is it important?

The CSRD is designed to bring sustainability reporting on par with financial reporting over time and monitor the progress of companies' behaviours. It requires more entities to provide mandatory sustainability disclosures.

Entities already subject to the reporting requirements under the NFRD will apply the new rules from 2025 (for FY 2024).

At a glance:

Main changes versus NFRD

Who?	Significant *extension of the scope* of sustainability reporting
When?	From 2025 based on 2024 reporting for groups/companies already under the NFRD Later for new joiners and SMEs
What?	• *Expanding the content* of sustainability reports • EU will create own reporting *standards (technical advice by EFRAG)* • *Double materiality* clearly defined • Integrating 'as much as possible' the global baseline
Where?	Sustainability report will be a mandatory component of the (consolidated) *management report (in a dedicated section)*
How?	*Electronic format* and *tagging* of sustainability reports mandatory
Responsibility?	Responsibility of management and governance and *new role of the audit committee* (or by delegation)
Enforcement?	Clear responsibilities for *preparation, oversight and enforcement*
Audit?	*Mandatory audit* of sustainability reports with *limited assurance;* later transition to *reasonable assurance*

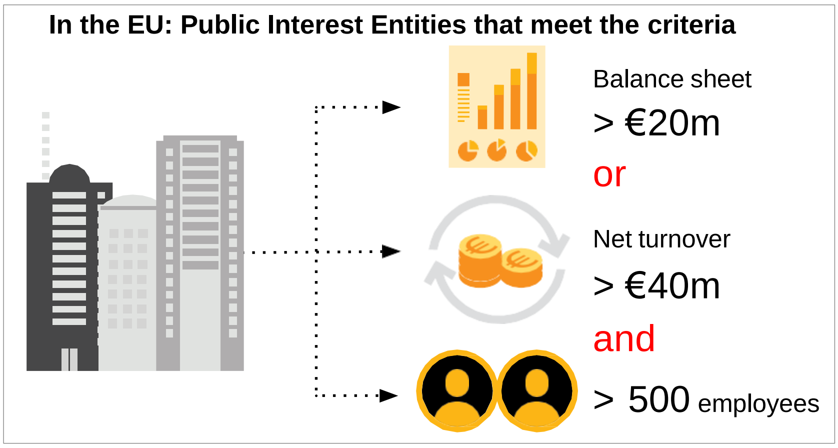
The CSRD aims to:

- harmonise and improve the quality of information published by undertakings, particularly environmental, social and governance information (sustainability-related information);
- provide financial undertakings, investors and the general public with relevant, comparable and reliable sustainability information;
- encourage investment that supports the transition to a sustainable economy in line with the European Green Deal.

Who does it affect?

The CSRD significantly expands the scope of undertakings subject to sustainability reporting requirements compared to those currently subject to the NFRD.

Companies currently subject to the NFRD



Public Interest Entities (PIEs) are defined by the Accounting Directive as:

- *undertakings listed on European regulated markets;*
- *credit institutions;*
- *insurance undertakings; and*
- *other entities designated by Member States as a PIE.*

The CSRD scope will now include all listed undertakings...

Under the CSRD, this obligation will apply to *all European undertakings whose securities (equity and debt) are listed on a European regulated market,* not just the large listed undertakings exceeding the thresholds above.

This includes non-EU companies listed in EU markets.

However, the Directive provides for certain adjustments and simplifications for *listed SMEs.* These include the possibility to disclose less information with simplified standards and to opt out of applying the new provisions of the Directive for another two years.

... other than listed micro-enterprises

However, the new Directive does not apply to listed micro-enterprises.

Micro-enterprises are undertakings that do not exceed the limits of at least two of the following three criteria:

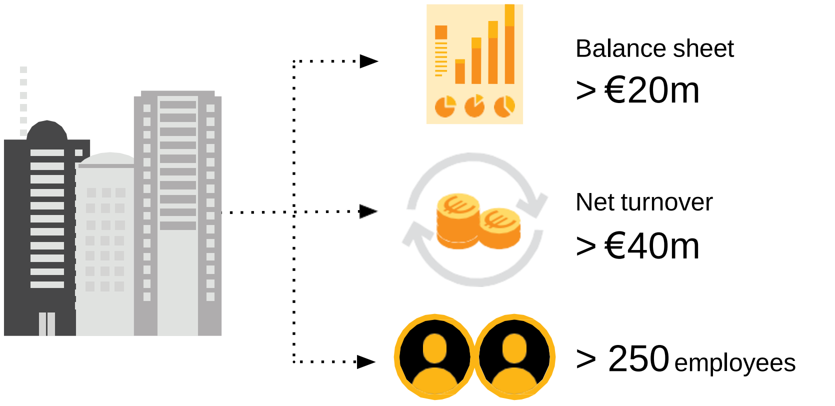
- balance sheet total: ≤ €350,000;
- net turnover: ≤ €700,000;
- average number of employees during the financial year: ≤ 10.

The CSRD scope will now include large non-listed undertakings

Under the Directive, all *large European undertakings* (listed or not listed) will be subject to sustainability reporting requirements.

Within the meaning of the Accounting Directive, *large undertakings* are those which exceed *at least two of the three* following criteria:

In the EU: Large undertakings that meet the criteria



This includes large EU undertakings with a non-EU parent company.

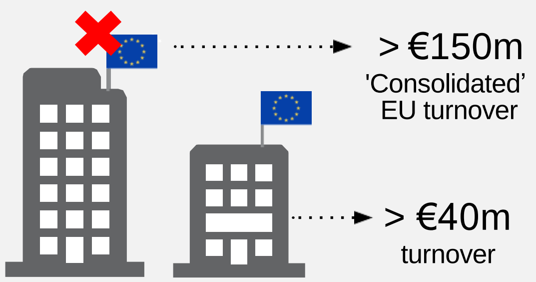
In order to reflect the specific nature of credit institutions and insurance undertakings, the CSRD introduces a definition of net turnover for them.

Non-listed SMEs may choose to disclose sustainability information on a voluntary basis.

Non-EU groups will be also impacted by CSRD

The CSRD also intends to have an extraterritorial effect. Non-European groups will also be subject to sustainability reporting obligations if:

Non-EU groups that meet the criteria



They generate net turnover in the EU of more than *€150 million* in each of the last 2 years and they have, at least, *one large or listed EU subsidiary or one EU branch* generating net turnover of more than *€40 million* in the preceding financial year.

→ *There could be cumulative cases where:*

- *a large EU undertaking with a non-EU parent company would have to publish sustainability reporting at the level of subsidiary entity (from 2026 based on FY 2025); and*
- *the same EU undertaking would have to publish consolidated sustainability reporting at the group level of the non-EU parent company (from 2029 based on FY 2028).*

Are there any exemptions?

Certain exemptions are available...

The CSRD exempts subsidiary undertakings from the obligation to report where they are included in the consolidated management report of their parent undertaking and where they indicate in their *own management report:*

- the name and registered office of the parent undertaking;
- weblinks to the consolidated management report of the parent undertaking including the sustainability statement and the assurance opinion thereon; and
- the fact that they are exempted from reporting sustainability information.

A European subsidiary of a parent undertaking established in a third country may also be exempted, under similar conditions as those described above, if the parent undertaking reports sustainability information in accordance with ESRS or equivalent sustainability reporting standards.

... except for certain public interest entities (PIEs)

However, some subsidiaries are excluded from the exemption regime for sustainability reporting. This is the case for PIEs that are:

- large undertakings (i.e. exceeding two of the three criteria defining large undertakings at European level; and
- whose *securities* (equity or debt) *are listed* on a regulated market.

Therefore, an SME, even if listed on a regulated market may be exempted from disclosing sustainability information if the conditions set for exemption (see on the left) are met.

The exemption regime for consolidated sustainability reporting operates independently from the exemption regime for consolidated financial statements. An undertaking can therefore be exempted from consolidated financial reporting requirements, but not from consolidated sustainability reporting requirements. This is the case if the company's ultimate parent prepares consolidated financial statements and consolidated management reports in accordance with EU law. Or there are equivalent requirements if the undertaking is established in a third country but does not prepare consolidated sustainability reports in accordance with EU law, or equivalent requirements.

Other aspects

More detailed disclosures

Undertakings subject to the CSRD will be required to provide more information than under the NFRD. Undertakings falling within its scope will be required to include the following disclosures in their management report:

- information necessary to understand the undertaking's impacts on sustainability matters, that is, environmental, social and governance matters; and
- information necessary to understand how sustainability matters affect the undertaking's development, performance and position (*double materiality*).

In particular, undertakings will need to provide:

- a *brief description of their business model and strategy,* including:
  - the *resilience* of the undertaking's business model and strategy to risks related to sustainability matters;
  - the *opportunities* related to sustainability matters;
  - the *plans* of the undertaking to ensure that its business model and strategy are compatible with the transition to a sustainable economy. This means the limiting of global warming to 1.5 °C in line with the Paris Agreement, the objective of achieving climate neutrality by 2050 and the exposure to coal-, oil- and gas-related activities.
- a description of the time-bound *targets* related to sustainability matters set by the undertaking. These include absolute greenhouse gas emission reduction targets for at least 2030 and 2050 and a description of the progress the undertaking has made towards achieving those targets;
- a description of the *role of the administrative, management and supervisory bodies* in sustainability matters and of the *expertise and skills* they need to fulfil this role or of their access to such expertise and skills;
- a description of the *undertaking's policies* in relation to sustainability matters;
- information about the existence of *incentive schemes* offered to members of the administrative, management and supervisory bodies which are linked to sustainability matters;
- a description of:
  - the *due diligence process* implemented by the undertaking with regard to sustainability matters and where applicable in line with EU requirements;
  - the *principal actual or potential adverse impacts* connected with the undertaking's own operations and its value chain, including products and services, business relationships and supply chain;
  - any actions taken by the undertaking, and the result of such actions, to *prevent, mitigate, remediate or bring an end to actual or potential adverse impacts.*
- a description of the *principal risks* to the undertaking related to sustainability matters, including the undertaking's principal dependencies on such matters and how the undertaking manages those risks; and
- *indicators relevant* to the disclosures referred to above.

This information will need to be prepared in accordance with the European Sustainability Reporting Standards, which will further expand disclosure requirements (for example in the area of pollution).

Progressive requirements for value chain disclosures in certain cases

Where applicable, the information referred to in the previous page shall contain details about the undertaking's own operations and about its *value chain.* This includes products and services, business relationships and supply chain.

For the first three years of the application of the CSRD, in the event that not all the necessary information regarding the value chain is available, the undertaking shall explain the efforts made to obtain the information about its value chain, the reasons why this information could not be obtained, and the plans of the undertaking to obtain such information in the future.

Simplified sustainability reporting requirements for listed SMEs

The CSRD created SME-specific sustainability reporting standards for listed SMEs. Listed SMEs may *limit* their sustainability reporting to the following information:

- a brief description of the undertaking's business model and strategy;
- a description of the undertaking's *policies* in relation to sustainability matters;
- the *principal actual or potential adverse impacts* of the undertaking with regards to sustainability matters and any actions taken to identify, monitor, prevent, mitigate or remediate such impacts;
- the *principal risks* to the undertaking related to sustainability matters and how the undertaking manages those risks; and
- *indicators* necessary to the disclosures referred to above.

As a reminder, the EU defines an SME as an undertaking that does not exceed at least two of the three following criteria:

- balance sheet total: ≤ €20m;
- net turnover: ≤ €40m;
- average number of employees during the financial year: ≤ 250.

Standardised sustainability reporting

The CSRD provides for the adoption by the European Commission of a set of European Sustainability Reporting Standards (ESRS), which will standardise sustainability disclosures and make information easier to compare.

In November 2022, EFRAG submitted draft European Sustainability Reporting Standards to the European Commission. The drafts will be followed by final standards after adoption by the European Commission, expected in June 2023.

The 12 draft ESRS correspond to the first set of reporting standards (see article on ESRS).

The CSRD provides for the adoption of the sector-specific and SME-proportionate standards as well as of standards for third country undertakings by 30 June 2024.

Sustainability reporting standards for SMEs
The CSRD provides for the adoption by the European Commission of specific sustainability reporting standards for SMEs. These are proportionate to their capacities and resources, and relevant to the scale and complexity of their activities.

Sustainability statement is to be included in a specific section of the management report

In order to make it easier to read and identify sustainability information, undertakings will have to disclose sustainability information in a *dedicated section* of their *management report*, or in the group's management report of parent undertakings.

Mandatory publication of the management report

To ensure that sustainability information is publicly available, the CSRD provides that all undertakings required to report sustainability information must publish their management report, with no possible exemptions.

The management report must be prepared in the European Single Electronic Format (ESEF)

In order to enable sustainability information to be used more efficiently, the CSRD requires undertakings to prepare their management report (or group management report) in the single European Single Electronic Format, that is the *XHTML format* already required for the preparation of annual financial reports by undertakings listed on EU-regulated markets.

In addition, undertakings are required to mark-up their sustainability reporting including the disclosures of Article 8 Taxonomy Regulation ('*digital tagging*').

There is no *exemption* for undertakings not listed on a regulated market.

A digital taxonomy to the EU sustainability reporting standards and the Article 8 Taxonomy Regulation disclosures will therefore be necessary to enable undertakings to tag the reported information in accordance with these standards.

New role of audit committee

The CSRD extends the role and responsibilities of a public interest entity's audit committee to the sustainability reporting.

→ possible delegation to another committee

ie by the administrative or supervisory body as a whole or by a dedicated body established by the administrative or supervisory body

Who will verify the sustainability statement?

To be considered reliable, the CSRD requires sustainability information in the management report to be reviewed by the statutory auditor or the audit firm that audits the financial statements.

Under the NFRD, the verification of non-financial information was an optional requirement at the discretion of individual Member States.

The statutory auditor will be required to issue an opinion based on a *limited assurance engagement* (and in the future based on a reasonable assurance engagement in order to have a similar level of assurance for financial and sustainability information) on:

- the compliance of the sustainability reporting with the requirements of the CSRD, including the compliance of the sustainability reporting with European reporting standards;
- the process carried out by the undertaking to identify the information reported pursuant to those reporting standards; and
- the compliance with the requirement to mark-up sustainability reporting and as regards the compliance with the reporting requirements of article 8 of the Taxonomy Regulation.

Member States may provide in their legislation that this task may also be entrusted to:

- a statutory auditor other than that carrying out the statutory audit of financial statements; or
- an independent assurance services provider.

Limited and reasonable assurance are both on the table:

October 2026: On or before 1 October 2026, the Commission will provide limited assurance standards for auditors to use when assessing the assurance of sustainability statement.

October 2028: On or before 1 October 2028, reasonable assurance standards should be provided.

When will the new CRSD come into force?

In order to give undertakings sufficient time to adapt to the new requirements of the CSRD, implementation will take place in four stages:

- *1 January 2024* for undertakings already subject to the NFRD (reporting in 2025 on 2024 data);
- *1 January 2025* for *large undertakings not currently subject to the NFRD* (reporting in 2026 on 2025 data);
- *1 January 2026 for listed SMEs*, as well as for small and non-complex credit institutions and captive insurance undertakings (reporting in 2027 on 2026 data). However, under the directive, listed SMEs may opt *out from the reporting requirements until 2028,* provided that they state in their management report why the sustainability information has not been provided;
- *1 January 2028 for non-EU undertakings* (reporting in 2029 on 2028 data).

The CSRD will need to be transposed into the various national laws of the Member States of the European Union. Each State has the possibility to provide for national provisions that are more stringent than those provided for in the directive and/or to decide on the provisions left to the discretion of Member States.

CSRD Impacts for companies

The CSRD is expected to impact almost every part of an organisation. While the ESRS are still under construction the below map reflects the expected impacts.

Risk and compliance

- Understand CSRD reporting obligations as a result of entity size and type (e.g. financial vs non-financial)
- Updates to risk management systems to capture ESG obligations
- Implementation and monitoring of supporting control environment

Investor relations

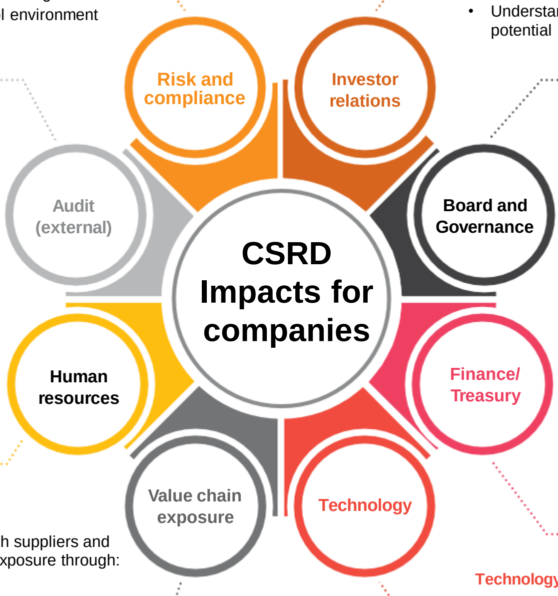
- Prepare for and manage investor enquiries and data demands relating to ESG credentials of reporting entity and investments made;
- Understand investor sentiment, potentially by jurisdiction, to potential impacts to capital from CSRD disclosures

Audit (external)

- Limited assurance initial followed by reasonable assurance meaning evidence trails and verification will be required for ESG data
- Selecting an external auditor is required with flexibility around auditor selection and European attempts to increase competition
- Statutory auditor of the financial statements is allowed to provide assurance of sustainability reporting

Board and Governance

- Incorporating sustainability into board reporting with clear responsibility and capability;
- Understand:
  - relationship between sustainability and the entity's business model and strategy
  - resilience of the business to sustainability risks
  - plans to ensure compatibility of the business and strategy to an economy that has transitioned to limit global warming to 1.5 °C



Human resources

- Collection of data for intangible disclosures around intellectual, human, and social and relationship capital
- Consideration of incorporation of ESG factors in remuneration of staff at all levels.

Finance and Treasury

- Assess ability to prepare data that reflects the financial exposure resulting from sustainability risk.
- Consider the need for shadow carbon pricing to for Treasury
- If responsible for annual reports in entirety, understand capability for single electronic reporting format
- Understand how capital providers are considering CSRD in their lending and investment decisions

Value chain

Supply chain

- Assessment of an entity's exposure to ESG from both suppliers and customers/investments to identify the entity's own exposure through:
  - suppliers/investments with low ESG credentials
  - suppliers/investments with no ESG data
- Understand end-to-end emission exposure to report under scope 3

End customer exposure

- Understand customer preferences based on ESG credentials and how exposure to your operations may affect their own CSRD reporting.

Technology

- Development and operationalising CSRD data collection, collation, monitoring and reporting
- Determine the extent to which a software solution is required for data capture, storage, and reporting

Key word is anticipation !

ESRS: what do you need to know?

In November 2022, EFRAG has submitted draft European Sustainability Reporting Standards to the European Commission (here).

Key points

EFRAG has handed over a first set of 12 draft European Sustainability Reporting Standards (ESRS) to the European Commission.

- The drafts will be followed by final standards after adoption by the European Commission, expected in June 2023.
- Concerns expressed during the public consultation on the Exposure Drafts gave rise to substantial changes.
- The draft ESRS specify the new sustainability reporting requirements based on the Corporate Sustainability Reporting Directive (CSRD), covering the full range of sustainability matters (environment, social and governance). Further sets of ESRS, will be developed in the future.
- The first companies within the scope of the CSRD will have to apply ESRS starting FY 2024.

What is the issue?

According to the draft Corporate Sustainability Reporting Directive (CSRD), adopted by the European Parliament on 10 November 2022, the European Sustainability Reporting Standards (ESRS) specify the content of the corporate sustainability reporting requirements in the EU.

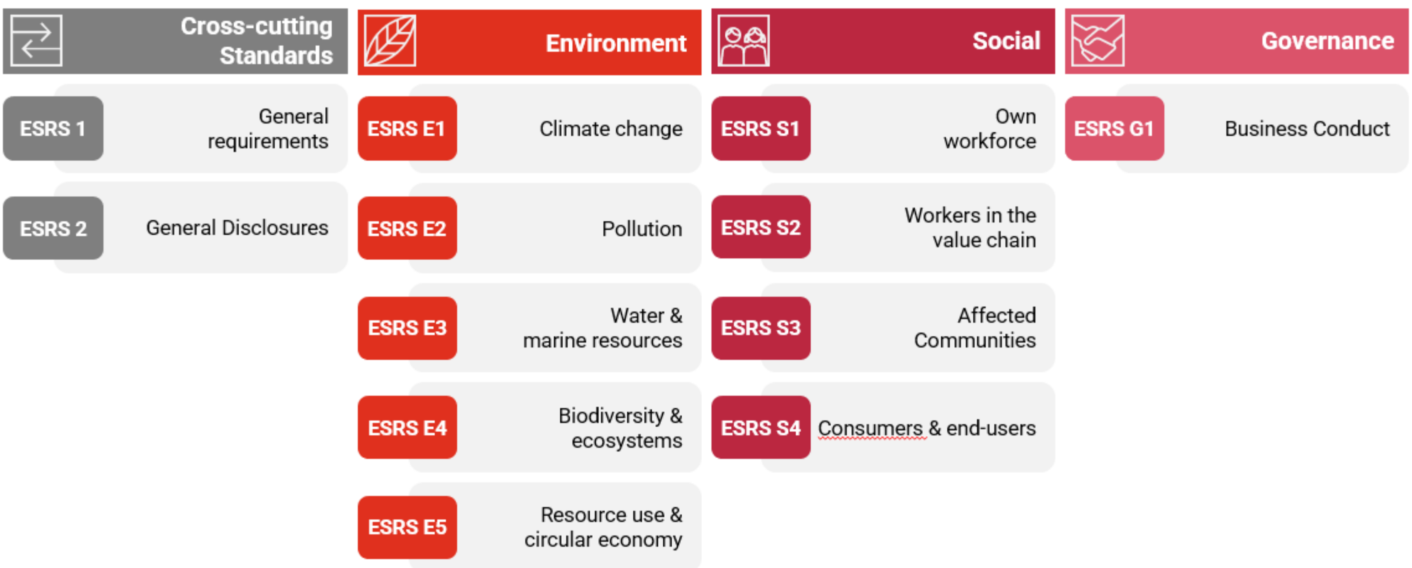
EFRAG has been mandated to develop draft ESRS to be submitted to the European Commission as Technical Advice.

EFRAG received more than 750 comment letters (see PwC's response here) after its public consultation on 13 exposure drafts (EDs) over summer 2022. Several changes were made including a reduction from 13 to 12 standards. EFRAG handed over its Technical Advice to the European Commission on 22 November 2022.

The 12 draft ESRS (see diagram below) correspond to the first set of reporting standards to be developed under the CSRD and include two *cross-cutting standards* (draft ESRS 1 on general requirements and draft ESRS 2 on general disclosures) which apply to all sustainability matters.

Topical standards cover:

- environment (climate change, pollution, water and marine resources, biodiversity and ecosystems, resource use and circular economy);
- social (own workforce, workers in the value chain, affected communities, consumers and end-users); and
- governance (business conduct).



What are the changes?

What is the impact?

The aim of the new CSRD and the ESRS disclosure requirements is to bring sustainability reporting on par with financial reporting. The objective of the ESRS is to provide valuable insights to a wide range of stakeholders on a company's sustainability-related impacts, risks and opportunities. The challenge will be a company's ability to implement the relevant processes to obtain the data in a timely manner.

How have the standards changed since the release of the ED ESRS for public consultation?

Following the comments received to its EDs, EFRAG made some extensive changes to its initial proposal. These include the following:

Revised architecture and enhanced international interoperability:

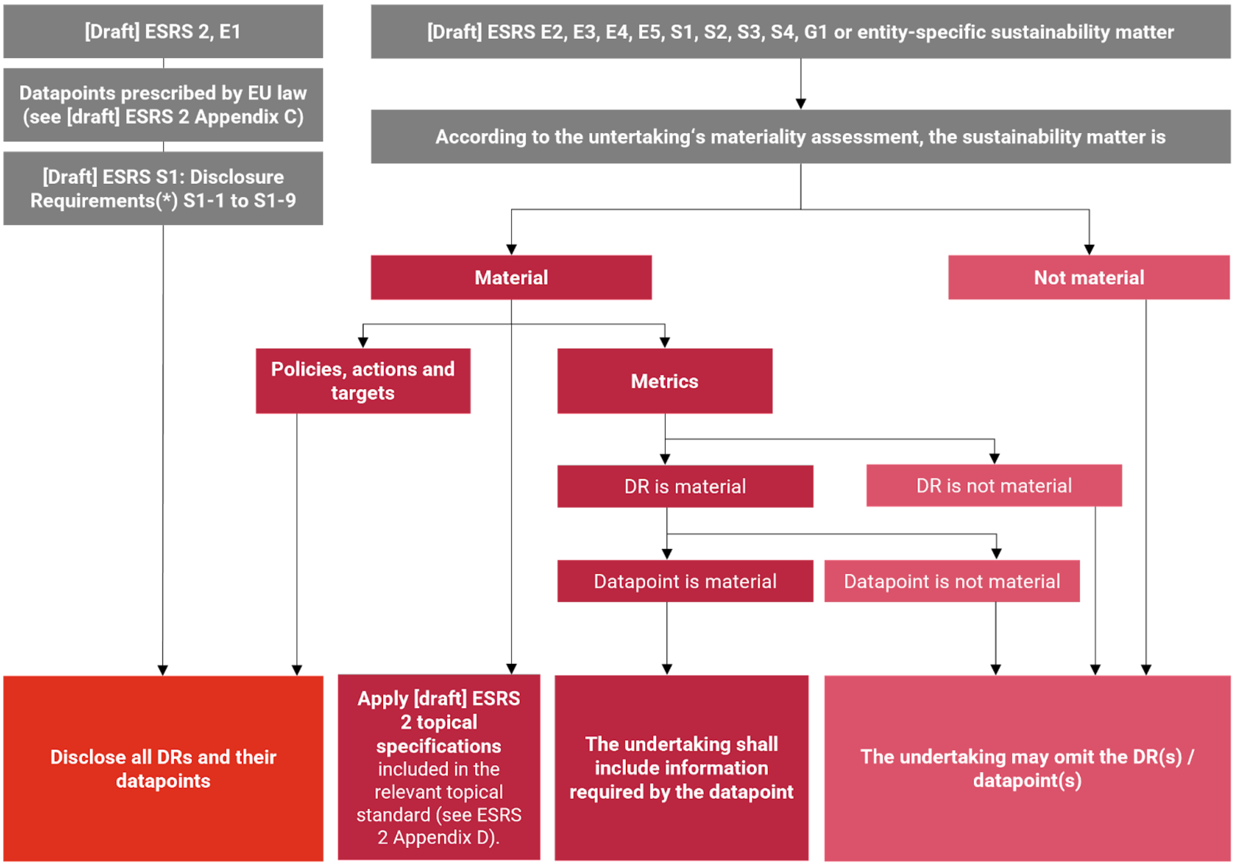
- 12 standards instead of 13, since ED ESRS G1 was deleted and its major disclosure requirements were incorporated into draft ESRS 2.
- The former structural approach of the three reporting pillars (Strategy; Implementation; Performance measurement) has been replaced by a four-pillar approach similar to the architecture of the TCFD and ISSB (Governance; Strategy; Impact, risk and opportunity management; Metrics and targets) to enhance international interoperability.
- In line with the new structural approach, the topical standards now require the disclosure of targets under the 'Metrics and targets' pillar.
- Key concepts, definitions and disclosure requirements in the cross-cutting and climate standards (including financial materiality and value chain) are aligned with those proposed by the ISSB. Changes and additions were made as required by the CSRD or other EU legislation. EFRAG strives to ensure that companies which comply with ESRS are also considered as complying with the ISSB standards to avoid unnecessary multiple reporting. Details on the level of interoperability are presented in Appendix V. EFRAG expects to work on a more detailed mapping when the IFRS Sustainability Standards are finalised.
- The Application Requirements of each standard now only contain: illustrations, examples, basis for calculation and methodologies, and definitions of concepts.

Revised materiality approach:

- The 'rebuttable presumption' whereby all disclosure requirements are presumed material unless the company has reasonable and supportable evidence to rebut this presumption, has been removed.
- A materiality assessment must still be prepared, but with a reduced scope since mandatory disclosures have been introduced.
- The mandatory disclosures to be reported irrespective of the outcome of the materiality assessment are in the cross-cutting standard Draft ESRS 2 and the topical standard Draft ESRS E1. In addition, there is an extensive list of mandatory disclosures that emanate from relevant EU legislation, in particular the Sustainable Finance Disclosure Regulation (SFDR).
- Regarding the remaining disclosure requirements, there are specific provisions to identify the information to be reported in the event that a sustainability matter is material according to the company's materiality assessment.

What are the changes?

- Appendix F to draft ESRS 1 contains an illustration of the necessary assessment to identify the information to be reported:



(*) only for undertakings with 250 or more employees

Figure based on draft ESRS 1, Appendix F: Flowchart for determining disclosures to be included

Simplification of the content:

- Disclosure requirements and its data points were streamlined (redundancies removed, finer definitions, and disclosure requirements and sub-topics merged or reorganised within the draft standards). According to EFRAG, the number of disclosure requirements has been reduced by approximately 40% and the number of datapoints has been halved.

Metrics:

- New metrics have been added (for example monetised total GHG emissions, employee turnover, gender distribution at top management, employees' age distribution) while other metrics have been deleted or rendered optional (for example avoided emissions, training costs, gender breakdowns for disabled workers, anti-competitive behaviour).

Phase-in provisions:

- These have been introduced to various disclosure requirements and data points. These relate to value chain information, potential financial effects from environment-related impacts, risks and opportunities and selected requirements of draft ESRS S1 such as adequate wages or social protection for non-employee workers (listed in Appendix D of draft ESRS 1).

Other aspects

When does it apply?

First-time application varies and starts from FY 2024 with reporting in 2025. The ESRS will apply to companies in scope of the CSRD.

Where should the information be reported?

The sustainability statement will be in a dedicated section in the management report.

Should the information be audited?

Yes, the CSRD introduces an obligation to provide assurance for the sustainability statement. Limited assurance should be provided initially with a planned transition to reasonable assurance in the following years.

What are the next steps?

The European Commission will assess the drafts. They will consult and request the opinion of several EU authorities and expert groups. These include ESMA (European Securities and Markets Authority) and the Member State Expert Group on Sustainable Finance. There might be another public consultation with a four-week consultation period in March or April 2023.

Adoption of the ESRS is expected by 30 June 2023 through Delegated Acts is, followed by a scrutiny period by the European Parliament and the Council. If no objections are raised, the ESRS will be directly applicable to all companies within the scope of the CSRD.

The standards provided are sector-agnostic. Over the following years, 40 additional sector-specific (that is industry-focused) standards will be released in phases.

In addition, the CSRD plans for the development of further sets of standards:

- ESRS specific to small and medium-sized undertakings (SMEs); and
- ESRS specific to non-EU undertakings.

The EFRAG Sustainability Reporting Board (SRB) identified items relating to topics covered by the first set that need further research:

- threshold for impact materiality, including a reference to the 'most significant' impacts, which is the threshold used in the OECD Guidelines, the UN Guiding Principles Reporting Framework and the GRI Standards;
- potential phase-in provision to allow financial market participants to postpone the inclusion of downstream value chain until the effective date of the future ESRS sector specific standards;
- addition of a data point disclosing the ethnicity of employees; and
- data availability and data quality for quantitative disclosures on financial effects arising from opportunities.

Where do I get more details?

You can find more information on the recent sustainability reporting initiatives in the EU and globally in our:

- EU Newsletter Sustainability Reporting #3, including a comprehensive overview of the ED ESRS;
- EU Newsletter Sustainability Reporting #4 with our comments on the ED ESRS, the ED from the International Sustainability Standards Board (ISSB) and the climate-related disclosures proposed by the Securities and Exchange Commission (SEC) - all released for public consultation in 2022.

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