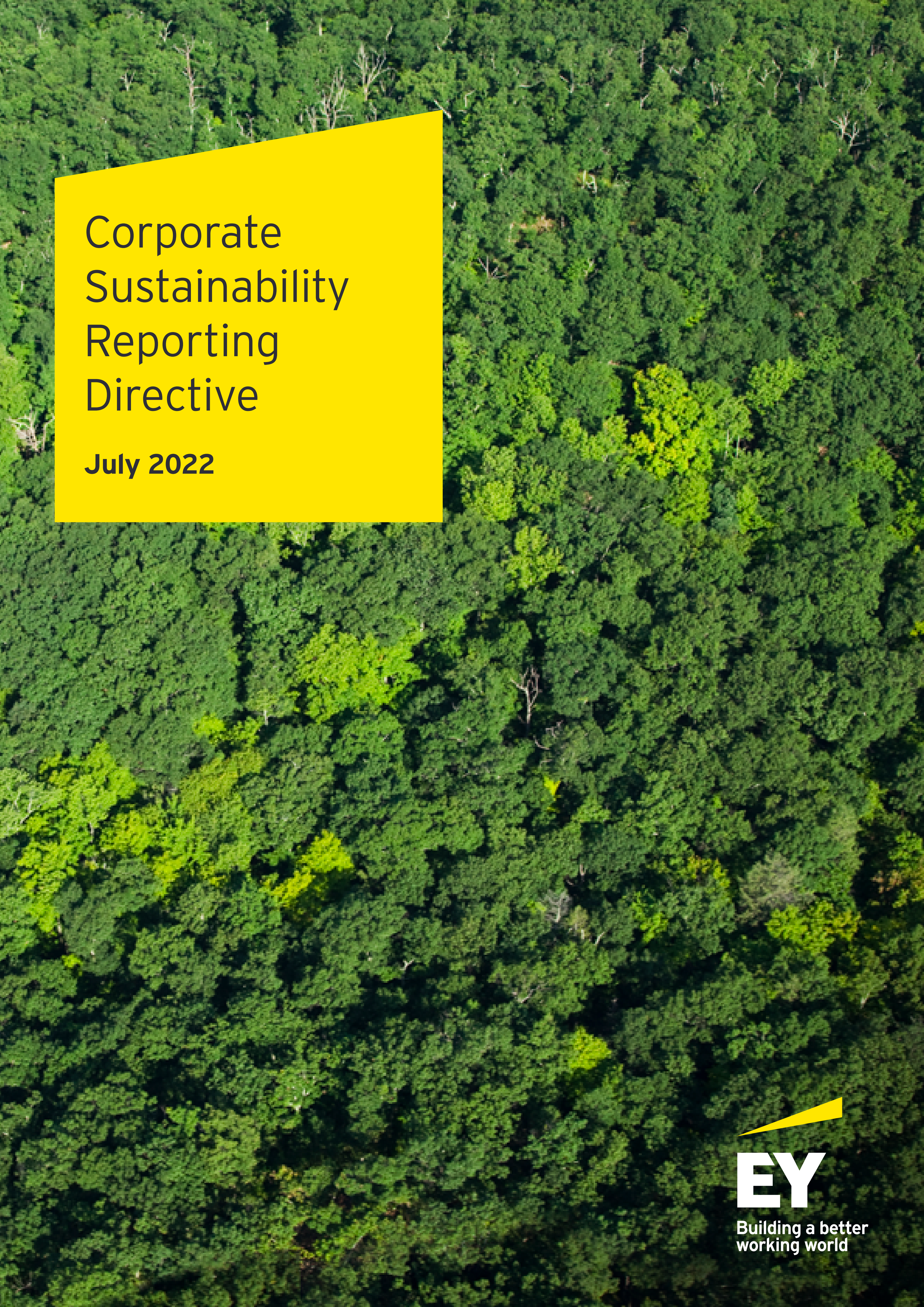
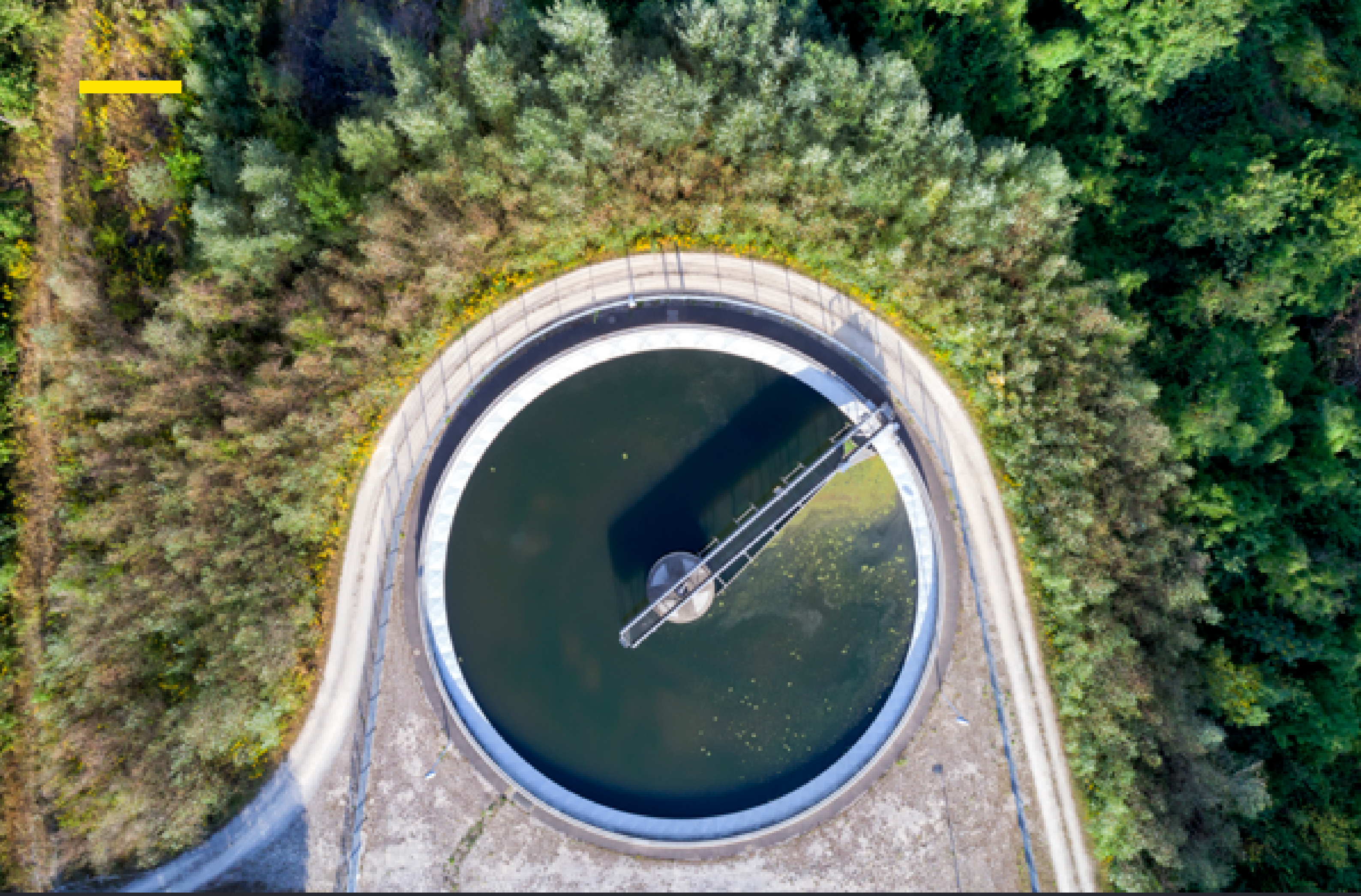
Corporate Sustainability Reporting Directive

July 2022



Building a better working world



Overview of the European Union (EU) new Corporate Sustainability Reporting Directive (CSRD)

The EU is set to adopt the CSRD in October 2022, which amends the previously applicable Non-Financial Reporting Directive (NFRD).

Context

The CSRD supports the European Green Deal, a set of policy measures intended to combat the climate crisis by transforming the EU into a modern, resource-efficient and competitive economy, with no net emissions of greenhouse gases by 2050.

Furthermore, the directive is part of the bigger Sustainable Finance package, which enables the Green Deal by helping to channel private investment behind the transition to a climate-neutral economy. The Sustainable Finance package includes the EU Taxonomy regulation (with the Climate Delegated Act), which provides clarification around the economic activities that most contribute to meeting the EU's environmental objectives. In addition, the package features six amending Delegated Acts on fiduciary duties, investment and insurance advice, which aim to ensure that financial firms include sustainability in their procedures and investment advice to clients.

Who will be covered by the directive?

The scope of the directive is considerably extended to apply to more entities.

EU companies

First, the directive will apply to all companies listed on the EU regulated markets, except for listed micro companies.[1] Listed small and medium-sized enterprises (SMEs) have until 1 January 2026 to comply with the reporting requirements, even though there's an opt-out clause until 2028.

Second, it will apply to a "large undertaking" that is either a EU company or a EU subsidiary of a non-EU company.

A "large undertaking" is a defined term in the Accounting Directive[2] and means an entity that exceeds at least two of the following criteria:

- A net turnover of €40 million
- A balance sheet total of €20 million
- 250 employees on average over the financial year

As a third category, the CSRD will apply to insurance undertakings and credit institutions regardless of their legal form.

There are also exemptions to the application of the CSRD. Most notably, a subsidiary will be exempt if the parent company includes the subsidiary in its report that complies with the CSRD. As mentioned previously, listed micro companies and non-listed SMEs fall outside of the scope, but can apply the provisions on a voluntary basis.

To respect the principle of proportionality, the European Commission will adopt mandatory sustainability reporting standards for large companies and separate, proportionate standards for SMEs. While SMEs listed on regulated markets will be required to use the proportionate standards from 1 January 2026, non-listed SMEs may still choose to use them on a voluntary basis.

Third-country companies

Non-EU companies with substantial activity in the EU market (net turnover of more than €150 million in the EU at consolidated level) and which have at least one subsidiary (large or listed) or branch (net turnover of more than €40 million) in the EU, are required to draft a sustainability report at the consolidated level of the ultimate third-country undertaking.

The EU subsidiary or EU branch are responsible for publishing the sustainability report of the third-country undertaking.

The sustainability reports of the third-country undertaking should be prepared according to separate EU reporting standards (i.e., standards different to the ones applying to EU companies). The undertaking can also report according to the standards applying to EU companies, or according to standards which are deemed equivalent according to a Commission's decision.

In order to ensure the quality and reliability of the reporting, the sustainability reports of third-country undertakings should be published alongside an assurance opinion by a person or firm authorized to give an opinion on the assurance of sustainability reporting, either under national law of the third country undertaking, or of a Member State.

[1] In order to qualify as a micro enterprise, a company shall remain below at least two of the following: (a) have fewer than 10 employees over the financial year on average; (b) a net turnover of €700.000; and (c) a balance sheet of €350.000.

[2] Accounting Directive (Directive 2013/34/EU).

Timescales

The 27 EU Member States are expected to transpose the new directive into national law 18 months after its entry into force. Companies that are already subject to the NFRD will need to comply with the amended rules for fiscal years beginning on or after 1 January 2024 (reporting in 2025 on 2024 data).

Other large companies not subject to the NFRD must start reporting from 1 January 2025 onward (reporting in 2026 on 2025 data).

Affected SMEs will not need to start reporting until 1 January 2026 (reporting in 2027 on 2026 data) to minimize the reporting burden. SMEs also have an opt-out option until 2028 to report.

For third-country companies, the new requirements apply from 1 January 2028 (reporting in 2029 on 2028 data).

Context

The CSRD aims to ensure that companies publicly disclose adequate information about the risks, opportunities and impacts of their activities on people and the environment (i.e., principle of double materiality).

Reported information should be consistent with EU regulations, including the EU taxonomy, an EU-wide classification system that establishes a list of environmentally sustainable economic activities. According to the directive, it should also be "comparable, reliable and easy for users to find and make use of with digital technologies."

The directive aims to reduce any unnecessary costs associated with sustainability reporting. Its goal is to enable companies to meet the growing demand for sustainability reporting in a cost-efficient manner. The revised directive amends four existing pieces of legislation:

- The Accounting Directive
- The Transparency Directive
- The Audit Directive
- The Audit Regulation

EU sustainability reporting standards

When companies report under the new directive, they will need to use a set of new European Sustainability Reporting Standards (ESRS) being developed by the European Financial Reporting Advisory Group (EFRAG). In March 2021, EFRAG published a detailed roadmap for developing the new sustainability standards, as well as proposals for mutually reinforcing cooperation between the global and EU standard-setting initiatives. In 2022, EFRAG set the new Sustainability reporting pillar with the creation of the EFRAG Sustainability Reporting Board (SRB) and the EFRAG Sustainability Reporting Technical Expert Group (SR TEG). A consultation on a first batch of draft ESRS was launched in April 2022 and the public consultation process is open until 8 August 2022.

The sustainability reporting standards aim to meet the requirements of an inclusive range of stakeholders. They adhere to the principle of double materiality, with both impact materiality and financial materiality perspectives being applied in their own right and without ignoring the interactions between them.

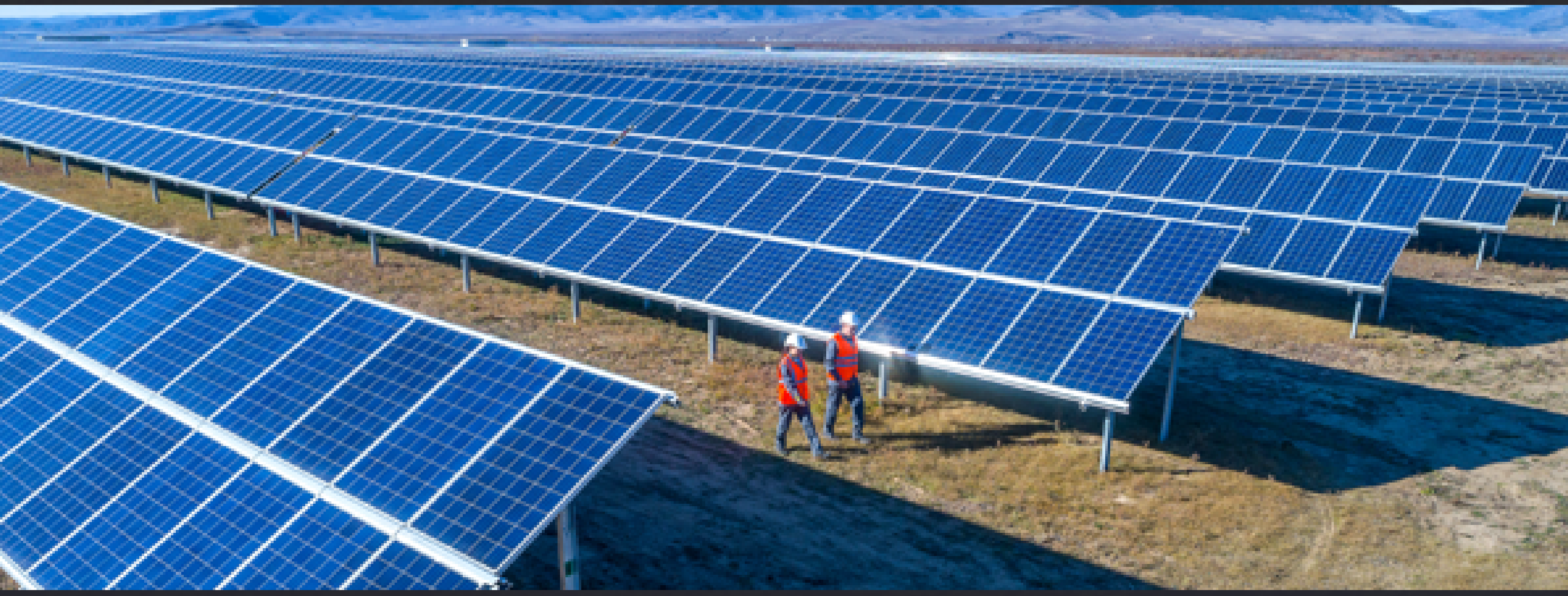
The European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) will need to provide an opinion on the technical advice provided by EFRAG before the standards are adopted.

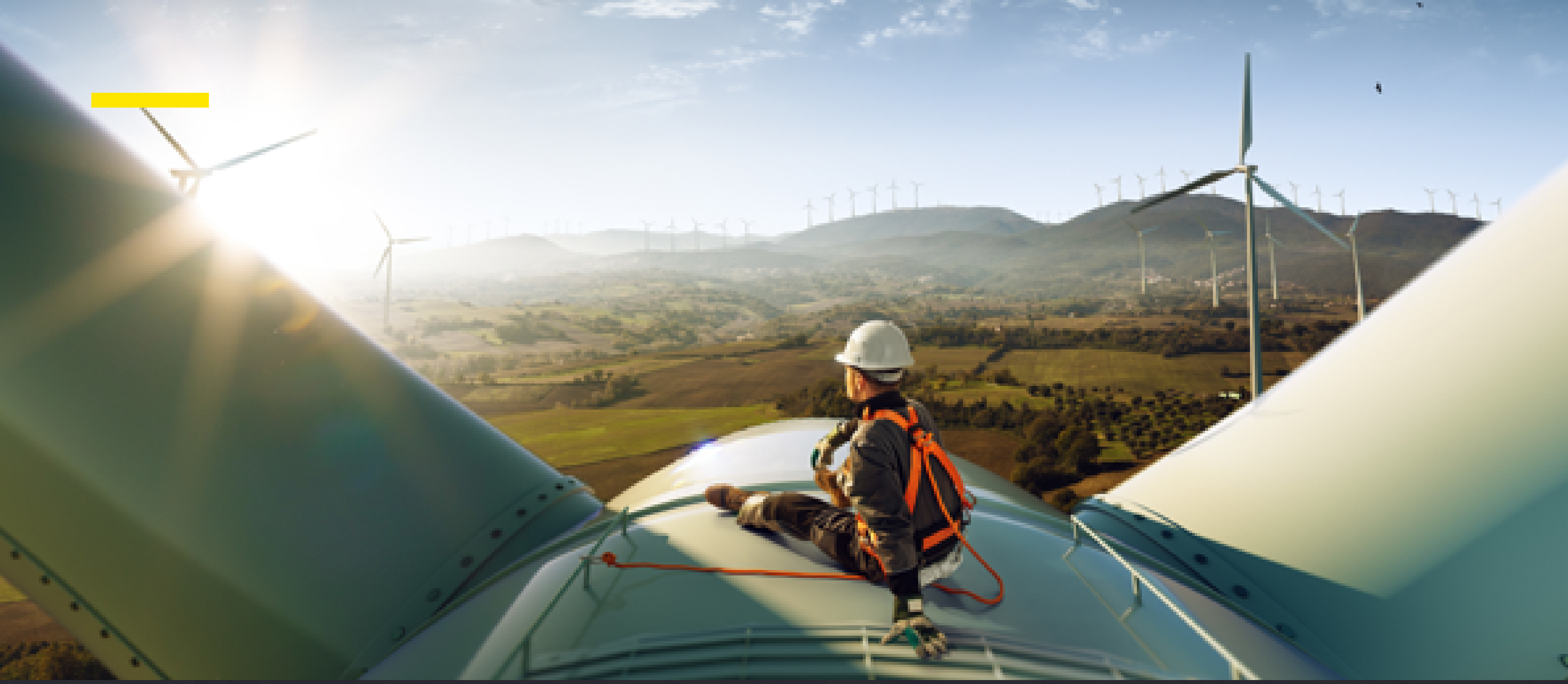
The Commission aims to adopt a first set of sustainability reporting standards, developed by EFRAG, by 30 June 2023. This set will specify the information that companies should disclose with regard to all sustainability topics, as well as any additional disclosure obligations for financial market participants.

Furthermore, the Commission aims to adopt a second set of reporting standards by 30 June 2024, with sector-specific standards, standards for listed SMEs, standards for non-EU companies and other complementary information that companies should report on.

The sustainability reporting standards shall ensure the quality and relevance of reported information, by requiring that it is understandable, relevant, verifiable, comparable and is represented in a faithful manner. The standards shall also avoid disproportionate administrative burden on companies, including by taking account to the greatest extent possible the work of global standard-setting initiatives for sustainability reporting, developed by the International Sustainability Standards Board (ISSB).

The Commission will review the standards every three years after the directive has been applied, to take into account new developments such as international standards.





What does the directive mean for companies?

The CSRD marks a major step change in corporate reporting. It has far-reaching implications for businesses on an individual basis, as well as for the future of sustainability reporting, both in Europe and globally.

Companies, regulators, standard-setters and assurance providers will all need to devote significant time and resources to prepare for implementation of the directive – within a short timeframe.

Businesses will be required to disclose more sustainability-related information than ever before, including information about their business models, strategy and supply chains. In addition, this information will either be assured by an external party for the first time, or more rigorously assured than it was before. The directive therefore plays an important role in helping to raise the bar globally when it comes to sustainability reporting.

The EY organization supports the long-term development of a comprehensive global framework for corporate reporting including a more robust set of reporting standards on sustainability matters. Developing a common European framework including a set of robust sustainability reporting standards is the only way to meet the market and social demands. Further steps toward greater levels of independent assurance are also important as sustainability information is increasingly used by all stakeholders in decision-making. Furthermore, the introduction of EU-wide standards gives businesses less flexibility about what information they disclose, and how they disclose it. Instead, the information they provide will be comparable with the information provided by their peers. Since investors will inevitably use this comparability to inform their decision-making, companies should increasingly expect capital to flow toward companies that can authentically demonstrate a strong sustainability performance.

In the long-term, the directive could stimulate changes in tax policy as governments use sustainability information reported by companies as the basis for developing incentives. The directive could also transform the way in which businesses approach their own decision-making processes and how they share their stories with their stakeholders.

Preparation

Given the significance of the directive – and the remaining time to get ready for it – companies should start preparing for its implementation now. It is important that in scope companies familiarize themselves with the directive and to consider what its requirements mean for their business on a practical level.

It is the responsibility of the board to ensure that the management team sufficiently prepares the company for the implementation of the new directive, with planning beginning straightaway. While the board will provide general oversight of the company's preparations, the audit committee also has an important role to play. It should oversee any new measuring and reporting processes that are established and monitor the effectiveness of systems and controls set up to help ensure the robustness of the information produced.

CFOs, their finance teams, and other colleagues across their businesses, have a lot of work to do to prepare for the implementation of the new directive. They need to understand what it means for their processes and controls, and assess whether any additional training is required.

Effectively, the directive will require companies to embark on a major change management exercise internally and shift the mindsets of key personnel to attribute as much importance to the sustainability reporting as they currently do to the reporting of financial information. Companies will need to consider how they identify and gather sustainability-related information, manage environmental, social and governance (ESG) risks, draw up policies, and set targets and KPIs. This may even be an opportunity to reassess whether those targets and KPIs are still relevant or in need of revision. Additional due diligence on companies' supply chains and a review of the effectiveness of their internal quality control and risk management systems may also be performed.

Risk management is another key consideration. To meet their obligations under the new sustainability reporting standards, companies will need to establish efficient procedures, adapt internal controls and ensure appropriate governance and monitoring is in place.

Furthermore, companies should review their arrangements regarding the external assurance of their sustainability information. Since the sustainability reporting standards are still in progress, companies will need to embark on their preparations without having certainty around what they are actually preparing for.

For this reason, companies should remain abreast of any updates, interpretation and communications from EFRAG during the standard-setting process so that they can get early visibility of how the standards are likely to look.

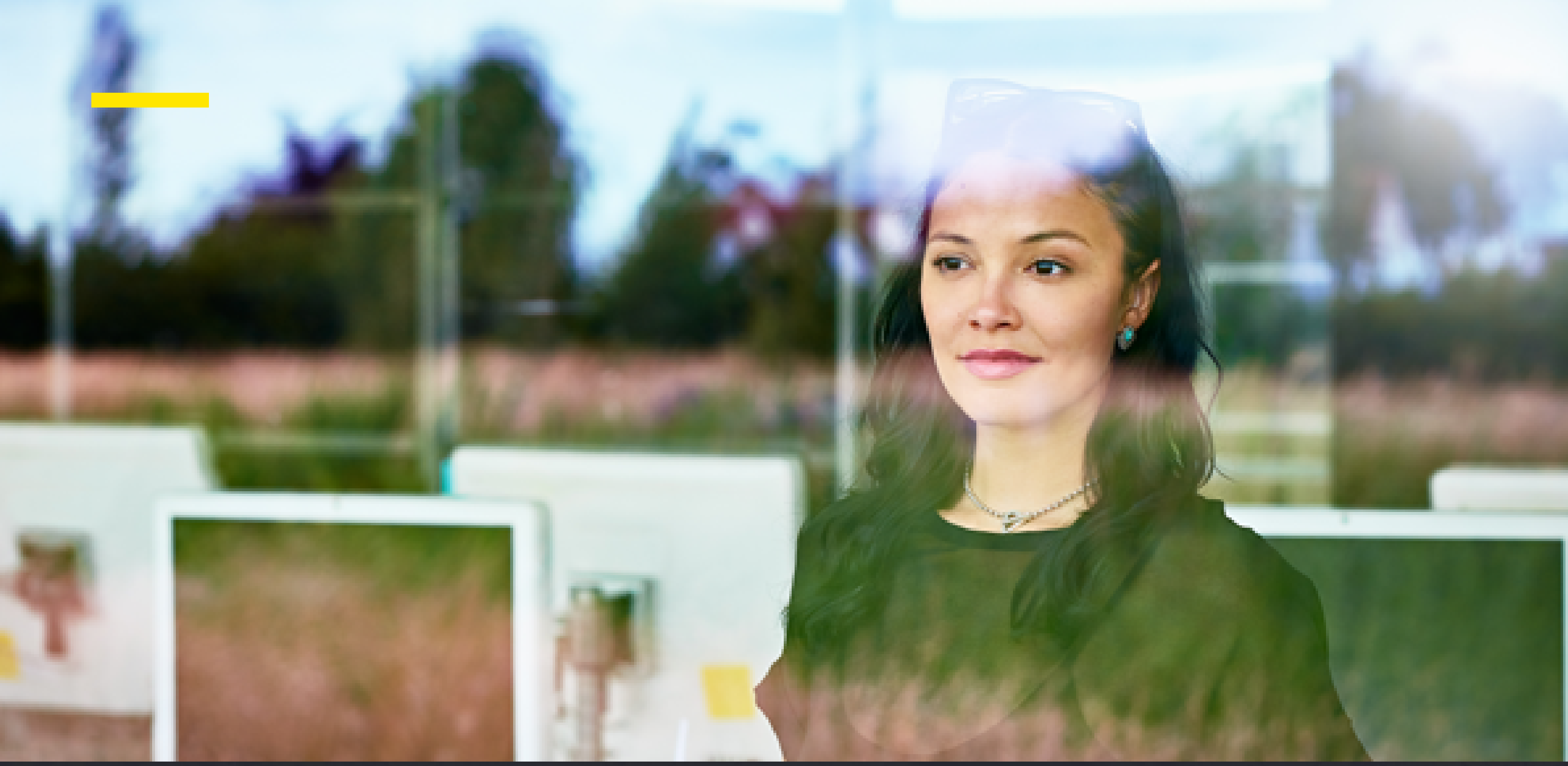
Costs

It is expected that 49,000 EU companies will be required to report sustainability information in the future, compared with 11,600 companies at present[3]. While the directive aims to "reduce the unnecessary costs of sustainability reporting for companies", it is estimated that preparers will incur significant one-off costs as well as recurring annual costs to comply with the directive. Nevertheless, the directive highlights that companies already faced a growing bill to provide sustainability information due to stakeholder demand. As a result, companies could effectively save by using the standards, depending on their size, on the basis the standards remove the need for additional information requests. The costs and savings will differ from company to company and will depend on the size and complexity of the business they are operating in.

SMEs

Listed SMEs will only be expected to provide sustainability reporting that is proportionate to their size and resources. As a result, the sustainability reporting standards will set out the information they need to disclose and how they should disclose it. Embarking on sustainability reporting will inevitably be a big step for SMEs that have never done it before. They may find it useful to seek professional expertise from external partners, to support them with the transition.

[3] Data extracted from the Impact Assessment issued by the European Commission on 21 April 2021 with specific reference to Annex 17: Cost Analysis performed by the Centre for European Policy Studies (CEPS) Non-financial reporting by large companies (updated rules) (europa.eu)



What will companies need to do in practice?

Companies that fall within the scope of the CSRD will need to make some significant changes to how they prepare and disclose sustainability information.

Management will need to:

1. Provide additional disclosures

Companies will be required to disclose:

- Information about their business strategy – and the resilience of their business model and strategy in the face of sustainability-related risks
- Any plans they may have, including implementing actions and related financial and investment plans, to ensure their business model and strategy are compatible with the transition to a sustainable and climate-neutral economy
- Whether and how their business model and strategy take account of the interests of stakeholders
- Any opportunities arising from sustainability that the company may be able to seize
- How implementation of the business strategy is likely to affect, or be affected by, sustainability matters
- A description of the time-bound targets related to sustainability matters that they have set themselves, including where appropriate absolute greenhouse gas emission reduction targets at least for 2030 and 2050, as well as their progress toward achieving these targets and a specification of whether their targets are based on conclusive scientific evidence
- A description of their sustainability policies
- The role of the board and management in relation to sustainability matters and their expertise and skills to fulfill this role or access to such expertise and skills
- Information about the existence of incentive schemes offered to the board and management which are linked to sustainability matters
- Detailed information about their due diligence process in line with EU requirements

- The principal actual and potential adverse impacts associated with the company's operations and with its value chain, including its products and services, business relationships and supply chain, actions taken to identify and track these impacts, and other adverse impacts which the undertaking is required to identify according to EU requirements on due diligence process
- Any actions taken, and the result of such actions, to prevent, mitigate or remediate or bring an end to actual or potential adverse impacts associated with the company's value chain
- A description of the principal risks that the company faces in relation to sustainability matters, including its principal dependencies and how it manages those risks
- The process carried out to identify the reported information
- KPIs relating to the above disclosures

All sustainability information disclosed should apply a forward-looking and retrospective view, and should be qualitative and quantitative. It should also take into account short-, medium- and long-term horizons, and consider the company's whole value chain, including its operations, products and services, business relationships and supply chain.

2. Report in accordance with new sustainability reporting standards

Companies will use the new sustainability reporting standards to disclose a set of information as part of their management report, thereby giving users an integrated view of their impact and performance, according to the following non-exhaustive factors:

- **Environmental** – climate change mitigation, greenhouse gas emissions, climate change adaptation, water and marine resources, resource use and circular economy, pollution, biodiversity and ecosystems
- **Social and human rights** – gender equality and equal pay, training and skills development, employment and inclusion of people with disabilities, and measures against violence and harassment in the workplace, working conditions, social dialogue, freedom of association, work-life balance and health and safety, respect for the human rights
- **Governance** – role of the board and management, internal control and risk management systems, business ethics and corporate culture, anti-corruption and anti-bribery, protection of whistle-blowers and animal welfare, management and quality of relationships with customers, suppliers and communities

As the standards are currently being developed, more details will be made available in the coming months.

3. Use digital tagging

Technology plays an important role in measurement, standardization and management of sustainability matters and data should be considered from the start. The digitalization of sustainability matters rationalizes the analysis of data provided by all the stakeholders and avoids the proliferation of different formats. Companies will need to rapidly enhance the systems of internal control over sustainability matters, and a digital-first approach should be used to streamline and automate sustainability processes, while providing greater levels of auditability and traceability.

To make their sustainability information easier for users to search via the upcoming European Single Access Point (ESAP) and machines to read, companies will be required to prepare both their financial statements and their management report in a single XHTML format and mark up sustainability information. The information reported will need to be tagged in accordance with a digital taxonomy.

Audit committees will have enhanced responsibilities under the new directive. They will need to:

- Monitor the company's sustainability reporting process, including the digital reporting process, and the process that the company followed to identify the information reported in line with the sustainability reporting standards
- Submit recommendations or proposals to ensure the integrity of the sustainability information provided by the company
- Monitor the effectiveness of the company's internal quality control and risk management systems and, where applicable, its internal audit function, with regard to the reporting of sustainability information, including digital reporting
- Monitor the assurance of annual and consolidated sustainability reporting
- Inform the company's administrative or supervisory body of the outcome of the assurance of sustainability reporting
- Explain to the administrative or supervisory body how it contributed to the integrity of sustainability reporting and what role it played in that process
- Review and monitor the independence of the assurance providers

Role of assurance providers

Under the existing NFRD, there is no systematic requirement for companies[4] to provide external assurance around their sustainability information. This is in stark contrast to their financial information, which is assured by their statutory auditor.

In its preamble, the Directive states that the "objective is to have a similar level of assurance for financial and sustainability reporting." Nevertheless, at present, the absence of a commonly agreed standard for the assurance of sustainability reporting raises the risk of misunderstandings and differing expectations around how sustainability information could reasonably be assured.

As a result, the EU adopted a "progressive approach" to enhancing the level of assurance required for sustainability information. Under the CSRD, there's a requirement for the company's statutory auditor, another auditor (Member State option) or an independent assurance services provider (IASP) (Member State option), to provide limited assurance around a company's reported sustainability information. There's the option of moving toward reasonable assurance – the standard of assurance provided for financial information – at a later stage.

For limited assurance, the opinion of the statutory auditor, or independent assurance services provider, should cover the following:

- Whether the company has complied with the EU sustainability reporting standards
- The process that the company followed to identify the information that it disclosed under the standards
- Whether the company complied with the requirement to mark up its sustainability reporting
- Whether the company's reporting complied with the requirements of Article 8 of the Taxonomy Regulation[5]

Member States should set out equivalent requirements for IASPs around quality, independence and oversight in line with the Audit Directive.

[4] Mandatory assurance is requested in France, Italy and Spain

[5] Sustainable finance taxonomy – Regulation (EU) 2020/852

Oversight and enforcement

EU Member States are required to extend their current frameworks for providing public oversight of statutory auditors and audit firms to cover assurance of sustainability reporting. The directive also requires that Member States establish a system of quality assurance review for assurance of sustainability reporting, as well as an investigations and sanctions regime for assurance providers that provide this service.

The individuals within the company who are responsible for the annual report will be required to confirm, to the best of their knowledge, that the management report is prepared in accordance with the sustainability reporting standards. The directive also calls for Member States to apply sanctions and other measures where sustainability reporting requirements have been infringed.

In brief

Companies only have a limited period of time to prepare for the implementation of the directive. As a result, it is essential they start taking action now to understand the impact of the directive on their sustainability strategy, as well as its impact on their corporate reporting, internal controls and other key business processes.

EY multidisciplinary teams are able to help companies and their stakeholders – including investors, policymakers and regulators – understand the directive and prepare for the huge changes it requires. These skilled teams incorporate a wide range of experience, from audit and assurance, corporate reporting, corporate governance, internal audit and tax, through to climate change and sustainability, digital transformation and people advisory services. They can help companies to identify their core sustainability issues, along with the associated risks and opportunities, and develop strategies that create long-term value for their own businesses, as well as society at large.

EY teams have considerable experience of helping companies to implement large-scale corporate reporting transformation in the past, having previously helped clients to adopt the NFRD. In addition, the EY organization has already undertaken limited assurance on information reported under the NFRD in France, Italy and Spain, since these countries required it. EY teams are committed to innovation and improving the disclosure practices of businesses to provide more reliable and accurate information in relation to sustainability matters. EY digital audit platforms also provide market-leading solutions for the automation and assurance of sustainability information.

Contacts

Christian Orth
EY EMEIA ESG Initiative Leader and
Europe West IFRS Desk Leader
christian.orth@de.ey.com

Andrew Hobbs
EMEIA Public Policy Leader
ahobbs@uk.ey.com

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EYG no. 006575-22Gbl

BMC Agency
GA 172211383
ED None

ey.com