A&L Goodbody

CORPORATE AND M&A

# Proposed directive on corporate sustainability reporting

## Political agreement has been reached on a proposed directive on corporate sustainability reporting.

The directive is intended to result in the reporting of transparent and reliable corporate sustainability information by relevant companies that can be easily accessed and compared by investors and other stakeholders.

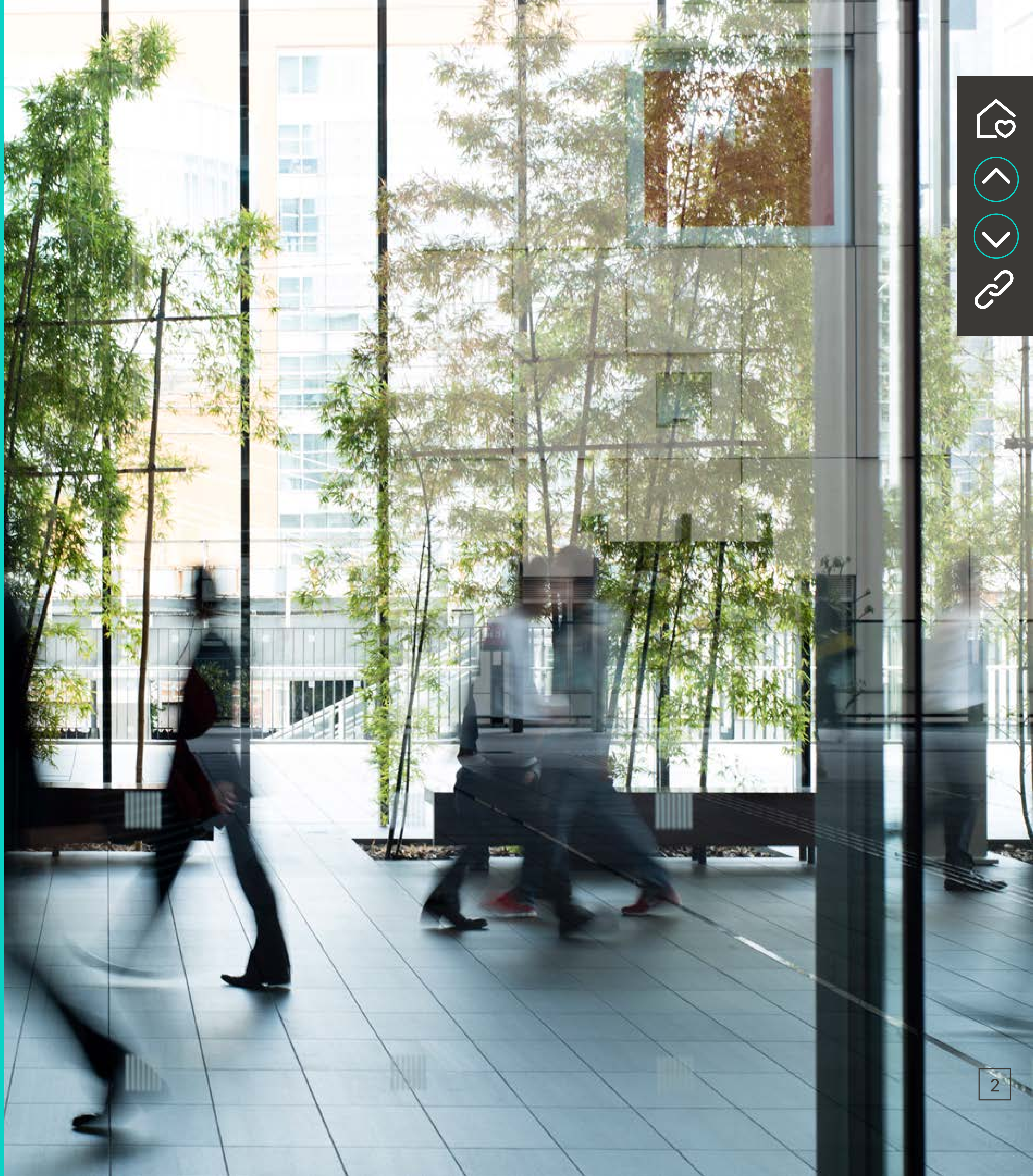
The CSRD represents a significant expansion in both the type of information to be disclosed by relevant companies (as well as a new assurance audit on the disclosure), and on the number of companies to which these obligations will apply.

9 MIN READ

In April 2021, the European Commission published its proposal for a directive on corporate sustainability reporting (**CSRD**) intended to result in the reporting of high quality corporate sustainability information by relevant companies that can be easily accessed and compared by investors and other stakeholders.

In June 2022, the European Parliament and the European Commission announced that political agreement had been reached on the text of the CSRD which was made public by the Permanent Representatives Committee (**Coreper**).

When the text is finalised and has gone through the legal-linguist process, it will be published in the Official Journal of the European Union (**OJEU**). 20 days after it is published in the OJEU the CSRD will come into force with Member States then having up to 18 months to transpose its requirements into domestic law. Thereafter, it will be applicable to the first phase of relevant companies in respect of a specified fiscal year (expected to be 2024).



## Background

The CSRD reflects the European Commission's commitment to advancing its European Green Deal and realising its strategic objectives on climate change arising from the 2021 United Nations Climate Change Conference (**COP26**). The CSRD aims to improve the flow of money to activities that are sustainable, and is a cornerstone of the Green Deal strategy. The CSRD builds on the existing disclosures required under the Non-Financial Reporting Directive (92014/95/EU) (**NFRD**) and extends (i) the scope of the information currently required to be reported under the NFRD; and (ii) the companies to which the disclosure regime applies. There is a sense among EU institutions that the disclosures required by the NFRD do not go far enough to accomplish the EU's goals when it comes to sustainability and the CSRD is intended to address these shortcomings.

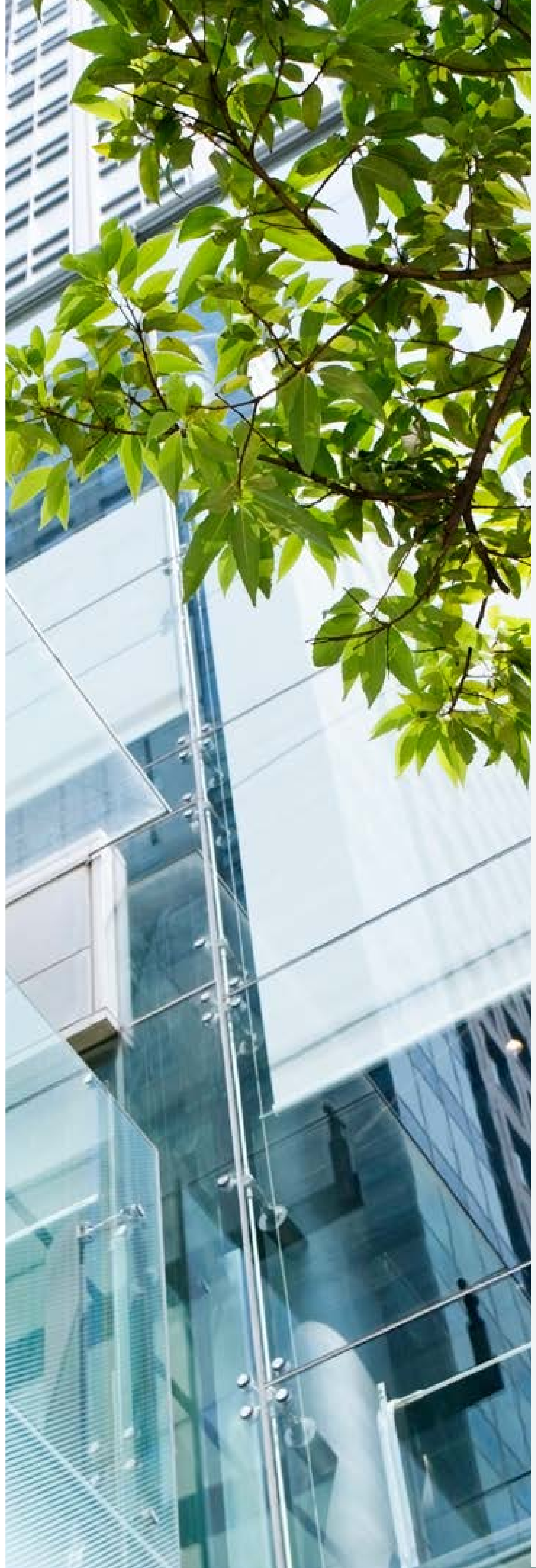
Pascal Durand who led negotiations for the European Parliament said:

> *"Today, information on a company's impact on the environment, human rights and work ethics is patchy, unreliable and easily abused. Some companies do not report. Others report on what they want. Investors, consumers and shareholders are at a loss. From now on, having a clean human rights record will be just as important as having a clean balance sheet.*
>
> *The European extra-financial audit market will be standardised, much more rigorous and transparent. Parliament succeeded in securing an opening of the audit market by member states in order to make room for new certified players to become major players and not just leave it in the hands of the financial auditors, notably the big four.*

Mairead McGuinness, Commissioner for Financial Services, Financial Stability and Capital Markets Union, said:

*"Sustainability reporting will now be on an equal footing with financial reporting. The Corporate Sustainability Reporting Directive will help drive the transition to a sustainable economic system built on innovation and investment opportunities.*

*It will enable companies to communicate and manage their sustainability performance more efficiently. Citizens will be able to measure the success of companies not just in financial terms but also assess how they impact people and the environment.*



## Anticipated timeline

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| **2022** | Publication in the Official Journal of the EU will bring the CSRD into force 20 days after the publication date: Member States will then have 18 months to transpose the requirements of the CSRD into local legislation – Consultation by EFRAG in respect of first set of draft sector-agnostic ESRS (defined below) concluded on 8 August with submission of draft ESRS to European Commission due by November |
| **2023** | Sector-specific ESRS due from EFRAG |
| **2024** | CSRD rules begin to apply to large public entities already subject to NFRD |
| **2025** | First CSRD reports due to be published by large public entities already subject to NFRD covering financial year 2024 – CSRD rules apply to other large entities not currently covered by NFRD |
| **2026** | CSRD reports to be published by non-NFRD large entities in respect of financial year 2025 – CSRD rules apply to listed SMEs, small and non-complex credit institutions and captive insurance undertakings |
| **2027** | CSRD reports for relevant SMEs due to be published for financial year 2026 (subject to opt-out to 2028 although from 2026 management reports will be required to include a "brief declaration" explaining why the entity has not chosen to provide sustainability information) |
| **2028** | Reports due from SMEs who have availed of the opt-out |
| **2029** | First non-EU entity reports to be published (subject to confirmation) |

## CSRD requirements

At the heart of the CSRD is the introduction of mandatory European sustainability reporting standards (**ESRS**), which the European Financial Reporting Advisory Group (**EFRAG**) is currently developing. The CSRD will amend the NFRD as well as the Audit Directive (2014/56/EU) and the Transparency Directive (2013/50/EU) and relevant regulations.

Companies that are required to report under the CSRD will be required to provide a range of information in compliance with the ESRS, which will include information on: (i) environmental factors (for example climate impacts of business activities (ii) social factors (for example equal opportunities, gender equality and equal pay, working conditions and human rights matters); and (iii) governance factors (for example business ethics and culture, anti-bribery and corruption measures, internal controls and risk management systems).

To reflect the alignment of the importance of sustainability information and financial information, and to achieve the goal of making this information as easily accessible and user-friendly as possible, sustainability disclosures will need to be made in a single report together with the financial reporting (which addresses the same reporting period) and digitally tagged so that it can be made available in line with the European Commission's 2020 capital markets union action plan via the European Single Access Point.

## Current non-financial disclosure regime in Ireland

The NFRD was transposed into Irish law by the European Union (Disclosure of Non-Financial and Diversity Information by certain large undertakings and groups) Regulations 2017, which requires 'applicable companies' to make certain non-financial disclosures, with additional disclosures required for 'large traded companies'.

These regulations require an applicable company to include, in respect of each financial year, a statement by its directors in their report which contains the information necessary for an understanding of the development, performance, position and impact of its activity relating to at least the following matters: environmental matters, social and employee matters, human rights, bribery and corruption. The statement should include a consideration of the risks to the business connected to these matters. Reports are also required to include statements as to business practices and supply chains. Each statement is to be provided on a comply or explain basis. Large traded companies are also required to include a statement setting out the company's policy in respect of the diversity of its board of directors, addressing various items.

Some Irish companies will be familiar with the existing Sustainable Financial Disclosures Regulation and the Taxonomy Regulation which aimed to establish an EU-wide classification system (or taxonomy) for environmentally sustainable economic activities. The CSRD goes further than these existing regulations as set out in more detail below.

## CSRD regime

Under the CSRD the following will be required to report sustainability information (implemented in stages as set out in the timeline):

- Large public companies already subject to the NFRD (publicly listed companies, banks and insurance companies with at least 500 employees)
- All large EU companies whether listed or not
- SMEs with securities listed on an EU regulated market (excluding listed micro-enterprises)
- Certain non-EU companies with significant activities in the EU

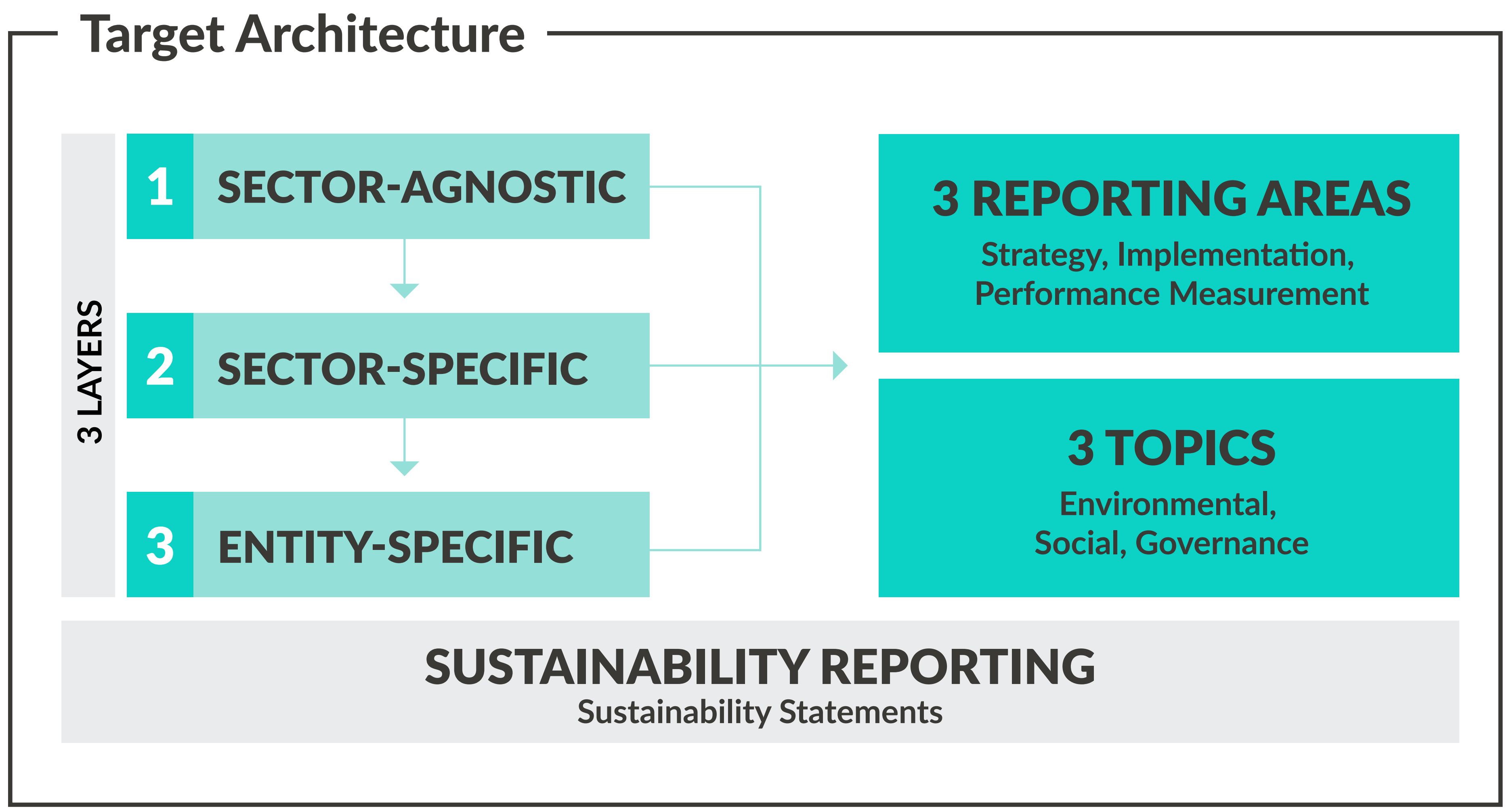
For the purposes of the CSRD, a large company is one which meets at least two of the following criteria: a balance sheet of more than €20m; and/or net turnover of more than €40m; and/or an average of more than 250 employees during the financial year.

For the purposes of the CSRD an SME is an entity which meets at least two of the following criteria: a balance sheet of between €4m and €20m; and/or net turnover of between €8m and €40m; and/or an average of between 50 and 250 employees during the financial year.

Non-EU companies that generate a net turnover of €150m or more in the EU and which have at least one subsidiary or branch in the EU will be required to report under the CSRD (reflecting the approach taken under the proposed Corporate Sustainability Due Diligence Directive). To ensure the proportionality of applying this regime to non-EU companies, it will only apply where the branch has a turnover of more than €40m or where a subsidiary is/are large or listed, and it is the branch or subsidiary that should make the report under lighter reporting standards.

Under the NFRD around 11,000 EU companies are required to report. The CSRD will reportedly increase the number of reporting entities to approximately 49,000 EU companies which generate in excess of 75% of total turnover attributable to EU companies.

It is significant that the political agreement reached between the European Parliament and the European Commission extends the application of the reporting requirements to non-EU companies (subject to nexus tests). This represents a departure from the Commission's proposal and reflects the EU's stated aim to be at the vanguard of the development of standards intended to contribute to climate stability globally.




# The ESRS in detail

EFRAG is in the process of developing the draft ESRS setting out a framework of required reporting at time of writing.

In a February 2021 final report, EFRAG laid out the intended structure of the ESRS on a conceptual basis of three by three: that is, three layers of reporting (sector-agnostic, sector-specific and entity-specific) against three reporting areas (strategy, implementation and performance measurement), on the three key topics (environmental, social and governance). The report included a diagram illustrating this architecture (see 'Target Architecture' figure).

This approach is intended to foster overall comparability among disclosing entities in a proportionate manner. Sector-agnostic disclosures are intended to capture disclosures that will be strictly necessary to allow comparability across sectors. These will then be supplemented by sector-specific disclosures which will reflect that certain industries and economic sectors will be have different impacts on particular ESG topics and may require additional disclosures in those areas (for example, each of a mineral extractor, a pharmaceutical company and a financial services provider will be subject to different impacts and risks in relation to each ESG 'topic'). Entities will also be required to "own" their double materiality assessment and supplement the sector-specific and sector-agnostic standards as may be required to "depict its own unique situation". Double materiality requires companies to report on both the financial implications that the reporting topics can have on a reporting company, as well the impacts that company operations have in relation to the reporting topics.

The first set of sector-agnostic ESRS were issued as exposure drafts (**EDs**) on 29 April 2022 and were the subject of public consultation. The consulation closed on 8 August 2022, with a variety of market participants (including for example the European Securities and Markets Authority (**ESMA**)) providing public responses to the EDs. On the current anticipated timeline, EFRAG is expected to deliver its final draft ESRS to the European Commission by November 2022. Some market participants including ESMA intend to provide further comments at that stage.The Commission has stated that it intends to adopt the ESRS by 30 June 2023. Sector-specific ESRS will be released for public consultation in 2023, will be submitted to the European Commission by 31 October 2023 and adopted by 30 June 2024. The Commission will review the ESRS every three years to take relevant developments into account.

The ESRS cover one standard on general principles for sustainability reporting and specific disclosure requirements focused on 11 environmental, social and governance topics. These are organized as follows:

| | |
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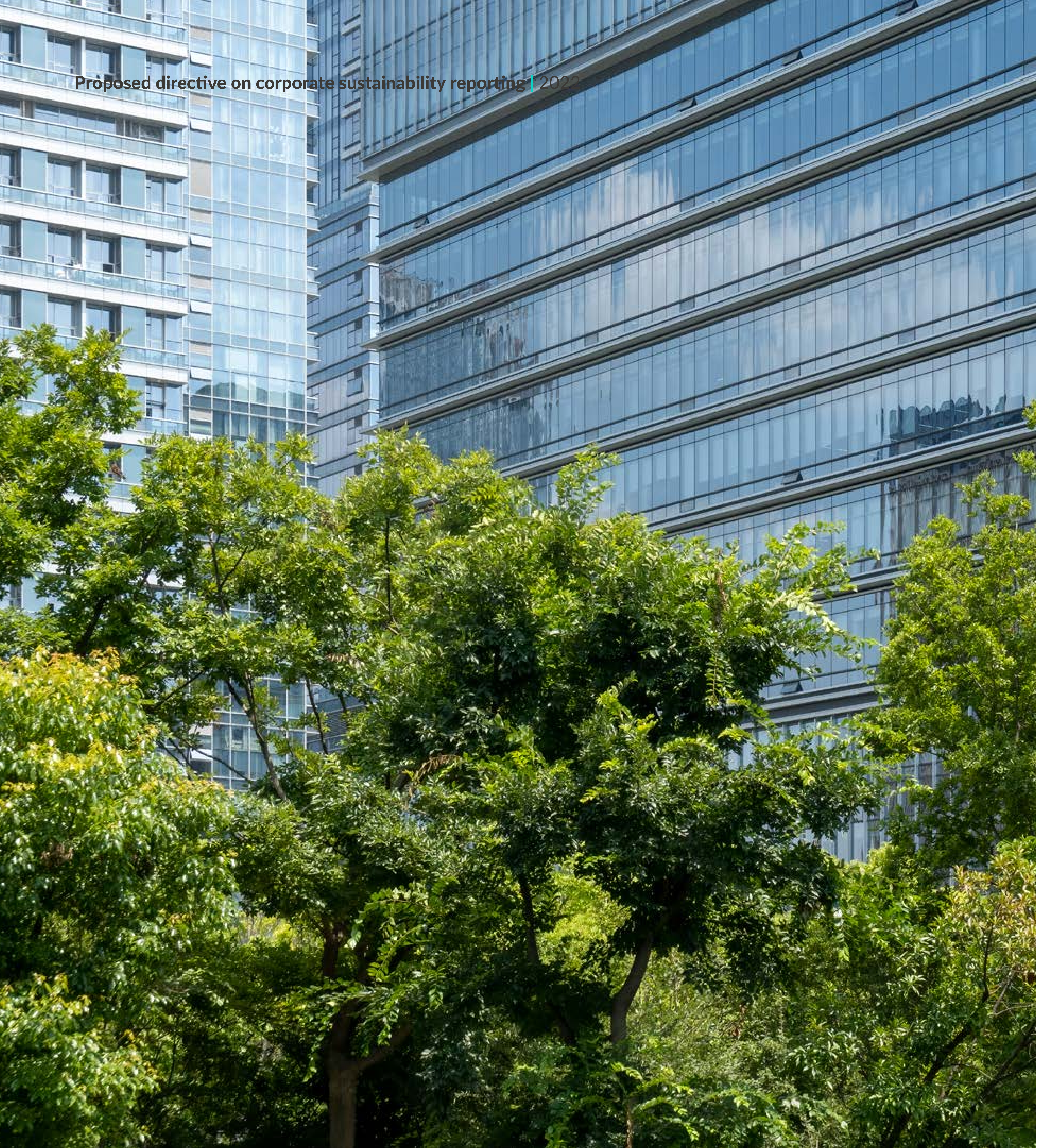
| **Disclosure topics** | Exposure Drafts have been issued for the following sub-topics: |
| | **Environmental:** climate change, pollution, water and marine resources, biodiversity and eco-systems, resource use and circular economy. |
| | **Social:** own workforce, workers in the value chain, affected communities, consumers and end users. |
| | **Governance:** governance, risk management and internal controls, and business conduct. |
| **Areas of disclosure for all topics** | Strategy and business model, governance and organisation, impacts risks and opportunities |
| | Implementation measures covering policies, targets, actions and action plans and allocation of resources. |
| **Guidelines for preparing sustainability reporting** | Performance measurement. Characteristics of information quality including relevance, faithful representation, comparability, verifiability and intelligibility |
| | Double materiality. |

The CSRD maintains the principle of double materiality disclosure in respect of climate and accordingly requires reporting on both sustainability risks to reporting companies as well as on the impacts the reporting companies themselves have on the environment and society.

The EU has stated that its adoption of double materiality reporting for the ESRS will protect a broader range of stakeholders than similar standards such as the IFRS Sustainability Disclosure Standards or the United States Securities and Exchange Commission's proposed rules on climate-related disclosures, which in the EU's view are geared towards protecting investors. Acknowledging that market participants will be familiar with these proposed standards EFRAG has prepared a reconciliation table between the existing exposure drafts of the ESRS and the IFRS standards.

While the EU intends to ensure that the ESRS are interoperable with other standards such as those proposed by the IFRS and the SEC using a 'building blocks' approach, some respondents to the ESRS consultation (such as ESMA) raised interoperability with other standards as a point that should be considered further by EFRAG.

As the intention is for the reporting to be proportionate and it is envisaged that standards applicable to SMEs that are required to report will be less onerous than those that apply to large companies, with applicable draft standards set to be made available for review in 2023.



## Sanctions:

The CSRD requires each Member State to provide for “effective, proportionate and dissuasive” penalties on non-compliant entities which will include public statements of censure and punitive fines (and which may include criminal sanctions where Member States so decide). Sanctions will be extended to include firms providing assurance in respect of the disclosures will also be subject to sanction.

## Reporting assurance

Information provided in the sustainability reports will have to be audited by a third party, an accredited independent auditor or certifier. The audits may be conducted on a limited assurance basis initially but by 1 October 2028 the Commission will adopt standards for reasonable assurance of sustainability reporting (following a feasibility assessment) which will then be the required audit standard.

# ALG practical recommendations

Given where the CSRD is in the legislative process, the text of the directive is likely to be materially as published. The introduction of legislation of this scope requires careful planning and implementation. Although it is likely that the effective date on which the CSRD will apply to even the largest and most sophisticated companies will not be before January 2024 with first reports due in respect of financial year 2024 in 2025, waiting until the directive comes into force is likely to be too late and will expose companies to risks of administrative penalties, civil (perhaps even criminal) liability and reputational damage.

Companies should therefore consider taking some or all of the below steps:

- Identify when the CSRD will apply to your company (if you are already required to report under NFRD, you will be required to report against financial year 2024).
- Identify the key ESRS which will be applicable/most relevant in your sector and identify peer companies which will be subject to CSRD, particularly those who may be subject to the first phase if your company will not be.
- Consider which ESRS will be most relevant to your business.
- Review responses to the consultation to assist with understanding what is proposed and likely areas of concern.
- Identify any gaps in your current monitoring and reporting that will need to be plugged by the time the regime comes into force and initiate remedial action to ensure data is being adequately captured.
- Begin to formulate action plans, targets and strategies against which to monitor progress and to report.
- Liaise with trusted advisors to identify requirements, action plans and work streams to prepare for compliance on a timely basis.
- Begin/continue Board briefings in relation to how and when CSRD reporting will impact on your company.
- Consider who will provide the audit assurance on reporting and begin engagement to ascertain their expected processes.

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## Resources

- Proposal for a Directive of the European Parliament and of the Council — READ MORE
- New rules on coporate sustainability reporting — READ MORE
- Politically agreed text of Proposed Directive — READ MORE
- Directive 2014/95/EU — READ MORE
- New social and environmental reporting rules for large companies — READ MORE
- Directive 2014/56/EU — READ MORE
- Directive 2013/50/EU — READ MORE
- S.I. No. 360/2017 – European Union Regulations 2017 — READ MORE
- Corporate Sustainability Reporting Directive — READ MORE
- EFRAG Report 2021 — READ MORE
- EFRAG Sustainability Reporting Standards — READ MORE
- IFRS Sustainability Disclosure Standards consultation — READ MORE
- United States Securities and Exchange Commission's proposed rules — READ MORE
- EFRAG Reconciliation table — READ MORE
- ESMA provides comments on first draft of european sustainability reporting standards — READ MORE
- Capital markets union 2020 action plan — READ MORE
- IFRS Sustainability Disclosure Standards — READ MORE
- A European Green Deal — READ MORE