SLAUGHTER AND MAY/

ESG: GETTING READY SERIES

CORPORATE SUSTAINABILITY REPORTING DIRECTIVE

GOVERNANCE & SUSTAINABILITY
Part of the Horizon Scanning series

WHAT

The European Union's ("EU") flagship sustainability reporting framework begins to bite this year. The Corporate Sustainability Reporting Directive ("CSRD")[1] and the cross-sector European Sustainability Reporting Standards ("ESRS") are set to bring about a sea change in sustainability reporting for both EU and non-EU businesses.

The CSRD requires reporting in accordance with standards (both cross-sector and, where applicable, sector-specific) developed by the European Financial Reporting Advisory Group ("EFRAG"), known as the ESRS. The cross-sector ESRS, which contain over 1,000 data points, cover a broad range of environmental, social and governance standards including, for example, standards in relation to climate, biodiversity and ecosystems, affected communities, consumers and end users, and business conduct. Certain undertakings who fall within scope of the CSRD will also need to provide disclosures in accordance with the EU taxonomy.

WHEN AND WHO

The reporting requirements under the CSRD will apply on a staggered basis and, at a high level, will apply as follows:

For financial years beginning on or after (requiring a report to be produced the following year):

1 January 2024	Public interest entities and issuers with securities on EU-regulated markets which are large and have more than 500 employees.
1 January 2025	All other large undertakings or undertakings that are parents of large groups.
1 January 2026	Listed SMEs,[2] small and non-complex credit institutions that are large undertakings or issuers and captive insurance or re-insurance undertakings that are large undertakings or issuers, provided they are, in each case, not a micro-undertaking.
1 January 2028	Non-EU companies with over EUR 150m turnover in the EU and that have a large EU subsidiary or branch.

1 Directive (EU) 2022/2464

2 We note that in-scope listed SMEs may opt out from sustainability reporting requirements until their financial year beginning on or after 1 January 2028. If they do so, they must state in their management report why the sustainability reporting was not provided.

Please refer to our CSRD flowchart at Appendix 1 for a visual overview of the CSRD's application and timings.

The Commission planned to adopt sector-specific and third country ESRS by June 2024, but has agreed plans to push this deadline back to June 2026 (the relevant legislation was adopted at the end of April, and is due to enter into force in the coming weeks), noting the desire to reduce red tape, and the fact that reporting obligations for non-EU companies with turnover above EUR 150m and a large EU subsidiary or branch will only start to apply in 2028 (at the non-EU parent company level).

WHY

The CSRD is designed to expand the scope of existing non-financial reporting obligations in the Accounting Directive[3] by increasing both the number of undertakings required to make disclosures and the level of detail in those disclosures. These changes are largely achieved by making amendments to the Accounting Directive and the Transparency Directive.[4] The new reporting framework is a key pillar of the European Green Deal (the EU's plan to reduce its carbon emissions to net zero by 2050).

The CSRD will require a shift in approach to reporting, both in terms of the amount of data that is being recorded and internal reporting structures. Even if a particular company may not be caught by the CSRD obligations immediately, it will take time for them to upskill their internal teams on obligations under the CSRD and to ensure that governance arrangements are updated accordingly.

GETTING READY

1. **Ascertain which group entities are in-scope of the CSRD.** Applying the scoping and exemption regimes under the CSRD to business structures, particularly for large groups with a non-EU parent, can be a complex exercise. Companies will often have multiple options for compliance with the CSRD, which will need to be considered thoughtfully when trying to map the incoming obligations onto a group's current approach to reporting. Strategic decisions will need to be made about how to begin CSRD reporting effectively, including whether it would be simpler and more efficient for out-of-scope parent companies to voluntarily report before they themselves are in-scope (this may be the case if, for example, relevant sustainability data are collected centrally at the parent company level).
2. **Prepare to conduct double materiality assessments.** The key differentiator for the CSRD/ESRS disclosure framework is its approach to double materiality. In summary, a double materiality approach requires disclosures of the impact of sustainability matters on a company (financial materiality), as well as the impact of the company on the environment and society (impact materiality). It is this second limb that companies may be less familiar with. Current guidance is not prescriptive but suggests that a company-specific approach be taken. Companies can use the time available to plan for their own double materiality assessments, including by familiarising themselves with the requirements, engaging with stakeholders, setting up new processes and improving data collection capacity.
3. **Follow discussions regarding the ISSB standards and interoperability.** The International Sustainability Standards Board's ("ISSB") sustainability disclosure standards (IFRS S1 and S2) were issued in June 2023 and are expected to set a new 'global baseline' for sustainability reporting.[5] With many countries, including the UK, Canada, Japan, Singapore, Brazil and Nigeria, looking to adopt them, issues of equivalence and interoperability with the ESRS have inevitably arisen. This is especially difficult for those groups with non-EU ultimate parent companies that will have to wrestle with how best to address their obligations under two similar-but-different disclosure frameworks. While EFRAG has made public comments suggesting a high degree of interoperability between the two frameworks, it is difficult to see how to get around the ESRS' and ISSB's different approaches towards materiality. Instead, the direction of travel appears to be towards alignment on financial materiality, while allowing additional disclosures in line with other standards (e.g. on impact materiality) to be included in the same report.

   It is worth watching this space closely, as we await further clarity and guidance regarding interoperability and the deadline for producing the first set of CSRD-compliant disclosures draws nearer.

3 Directive 2013/34/EU

4 Directive 2004/109/EC

5 For more information, see our Getting Ready briefing on the ISSB's IFRS S1 and S2

4. **Consider the value chain reporting requirements carefully.** The CSRD framework requires companies to make disclosures relating to their "value chain". This is defined broadly to include the full range of activities, resources and relationships related to the undertaking's business model and external environment. This definition includes upstream (e.g. suppliers) and downstream (e.g. customers, distributors) actors and direct and indirect business relationships. In-scope companies need to disclose material impacts, risks and opportunities in their value chains, with a focus on geographies, sectors, operations, and actors where they are likely to materialise.

   There has been some concern about the difficulty of making these disclosures. The broad definition means that the perimeter of the reporting obligations is not straightforward. Organisations might also face practical difficulties when seeking information from value chain partners. They may not have the contractual right to request the information and suppliers may not have the ability to produce it. In these cases, additional resources might have to be expended to build up due diligence capabilities and communication channels. Companies may also wish to revisit supplier and customer contracts to introduce provisions (e.g. cascading information rights along the supply chain) that allow the organisation to satisfy its reporting obligations.

   Partly to reflect that difficulty, the ESRS introduce a three-year grace period that limits the information that needs to be reported in cases where companies are unable to obtain it. Companies may wish to use the grace period to scale up internal data collection and communication processes, to ensure that they are well placed to cope with the new requirements.

5. **Consider the level of assurance that will be required.** The CSRD framework requires sustainability disclosures to be independently assured. However, although in-scope entities are required to obtain limited assurance from financial years beginning on or after 1 January 2024, the EU does not have to implement an EU-wide assurance standard until 2026, leading to a potential standards vacuum. This has led certain Member States to begin work on their own CSRD-compliant assurance standards. Companies may also find it helpful to refer to the draft ISSA 5000 global sustainability assurance standard for guidance in the meantime (the final standard is expected to be issued by the end of 2024). While the EU has not committed to its adoption, they did work closely with the International Auditing and Assurance Standards Board ("IAASB") in its drafting, and it is possible that a European assurance standard would follow the approach taken by the IAASB.

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Is the entity incorporated in the EU?

CSRD reporting obligations apply for financial years beginning on or after:

YES (entity incorporated in the EU)

Is the entity a **small and non-complex credit institution** OR a **captive insurance/ reinsurance undertaking?**
- YES → Is the entity **large**?
- NO → Is the entity: **large** or the parent of a **large group** AND an **issuer** and/or **PIE** AND with more than 500 employees?
  - YES → 1 JAN 2024
  - NO → Is the entity **large** or the parent of a **large group**?
    - YES → 1 JAN 2025
    - NO → Is the entity: an **SME** AND an **issuer** AND **non-micro?****
      - NO → OUT OF SCOPE
      - YES → 1 JAN 2026

Is the entity **large**?
- YES → 1 JAN 2026
- NO → Is the entity: an **SME** AND an **issuer** AND **non-micro?****
  - YES → 1 JAN 2026
  - NO → OUT OF SCOPE

NO (entity not incorporated in the EU)

Is the entity an **issuer**?*
- YES → Is the entity a **small and non-complex credit institution** OR **captive insurance/ reinsurance undertaking?**
  - YES → Is the entity **large**?
  - NO → Is the entity: **large** or the parent of a **large group** AND with more than 500 employees?
    - YES → 1 JAN 2024
    - NO → Is the entity **large** or the parent of a **large group**?
      - YES → 1 JAN 2025
      - NO → Is the entity: an **SME** AND **non-micro?****
        - NO → OUT OF SCOPE
        - YES → 1 JAN 2026
- NO → Is the entity an ultimate group parent?

Is the entity **large**?
- YES → 1 JAN 2026
- NO → Is the entity: an **SME** AND **non-micro?****
  - YES → 1 JAN 2026
  - NO → OUT OF SCOPE

Is the entity an ultimate group parent?
- NO → OUT OF SCOPE
- YES → Did the entity have EUR 150m in turnover in the EU at an individual or group level in the last two consecutive financial years?
  - NO → OUT OF SCOPE
  - YES → Does the entity have a **large** EU subsidiary?
    - YES → 1 JAN 2028
    - NO → Does the entity have an EU subsidiary which is: an **SME** AND an **issuer** AND **non-micro?**
      - YES → 1 JAN 2028
      - NO → Does the entity have an EU branch generating over EUR 40m in turnover in the preceding financial year?
        - YES → 1 JAN 2028
        - NO → OUT OF SCOPE

DEFINITIONS

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Issuer: natural person or undertaking whose securities are admitted to trading on an EU regulated market

PIE: listed companies governed by the law of an EU member state, non-listed banks, certain insurance undertakings, credit institutions and undertakings designated as PIEs by Member States

*** **Large/Large group:** undertaking/group exceeding two of the following three criteria:

I. balance sheet total: EUR 25,000,000;
II. net turnover: EUR 50,000,000; and
III. average number of employees during the financial year: 250

SME: undertakings not exceeding the limits of at least two of the three criteria for an undertaking to be "large" and which are not micro

Non-micro: undertakings exceeding two of the following three criteria:

I. balance sheet total: EUR 450,000,
II. net turnover: EUR 900,000,
III. average number of employees during the financial year: 10

Small and non-complex institution: as defined in point (145) of Article 4(1) of Regulation (EU) No 575/2013

Captive insurance undertaking / reinsurance undertaking: as defined in points (2) and (5) of Article 13 of Directive 2009/138/EC

* Non-EU issuers which only have high denomination debt securities of at least EUR 100,000 per unit, or 50,000 where the debt securities were admitted to trading before 31 December 2010, may be exempt from the CSRD under the wholesale debt exemption in the Transparency Directive.

** In-scope SME issuers may opt out of sustainability reporting requirements until financial years beginning on or after 1 January 2028. Where they do so, they must state in their management report why the sustainability reporting was not provided.

*** In October 2023, the European Commission announced plans, set out in a Delegated Directive, to adjust and round up the size criteria (i.e., the balance sheet total and net turnover) for micro, small, medium-sized and large companies by 25% to account for inflation. This is expected to result in reduced reporting requirements for more than one million companies. The Delegated Directive was published in the Official Journal on 21 December 2023, and entered into force on the third day after its publication. Member States must bring into force laws, regulations and administrative provisions necessary to comply with the Delegated Directive by 24 December 2024. The figures on the left have been adjusted by 25% as a result.

This document provides general information and does not constitute legal advice or seek to be an exhaustive statement of the law. If you do require legal advice on a specific legal issue, please get in touch with your usual contact at Slaughter and May.