

NEW EUROPEAN DISCLOSURE REQUIREMENTS TAKE SHAPE

Corporate Sustainability Reporting Directive (CSRD) and the European Sustainability Reporting Standards (ESRS) for a new era of sustainability disclosure

At the end of June 2022 the European Council of Ministers, the European Parliament, and the European Commission reached a political compromise on the contents of the Corporate Sustainability Reporting Directive (CSRD). According to the EU's plans, the CSRD is to become the backbone of sustainability reporting within the EU. Compared to previous directives, the CSRD significantly expands the scope of both the companies who will be subject to the directive and the information to be reported on sustainability. Upcoming deadlines for the implementation of this new standard are going to place significant pressure on organizations as they progress through this transition. An efficient, targeted, and timely implementation is indispensable to ensure compliance with CSRD and the accompanying European Sustainability Reporting Standards (ESRS).

AT A GLANCE: WHAT'S NEW AND WHAT DOES IT MEAN PRACTICALLY FOR REPORTING ORGANIZATIONS?

The reporting requirements of the CSRD will be specified in the European Sustainability Reporting Standards (ESRS), which is currently being developed by EFRAG, as technical advisor to the European Commission

<p>WHO</p> <p>does it apply to?</p>	<p>Scope of affected companies has been greatly expanded</p> <p>Companies that meet two of the three criteria:</p> <ul style="list-style-type: none"> → > 250 employees → > €40M turnover → > €20M total assets <p>Additionally, any listed companies and non-EU companies which have net sale > €150M in the EU and have at least one subsidiary or branch in the EU will need to follow the new standard.</p>
<p>WHAT</p> <p>does it require?</p>	<p>Scope of sustainability information to be reported is broader and deeper</p> <p>Information based on “double materiality” includes information which is</p> <ul style="list-style-type: none"> → sector-agnostic (disclosure requirements applicable for all companies in the scope of the CSRD) → sector-specific (disclosure requirements that apply to companies in certain sectors) and → entity-specific (sustainability matters that need to be identified and assessed by the organization) information. <p>Together, they cover</p> <ul style="list-style-type: none"> → Environmental, Social, and Governance information → General sustainability information <p>All organizations that fall into the scope of the CSRD are required to report on the EU taxonomy (Turnover, Capital expenditures (CapEx), Operating expenses (OpEx)), as well.</p> <p>Assurance requirements</p> <ul style="list-style-type: none"> → Member States must ensure that the statutory auditor/audit firm checks that the report has been provided. → External audit with initial limited assurance (reasonable assurance is expected at a later stage). → Supervisory Board is given an extended monitoring obligation, including independence and quality of the auditors in addition to the digital reporting process and corporate control systems.
<p>WHERE</p> <p>does the information need to be reported?</p>	<p>Publication in the management report</p>
<p>WHEN</p> <p>does the report need to be prepared?</p>	<p>Phased implementation approach:</p> <ul style="list-style-type: none"> → FY 2024 for companies subject to the Non-Financial Reporting Directive (NFRD) → FY 2025 for companies which are not subject to the Non-Financial Reporting Directive (NFRD) → FY 2026 for listed small and medium enterprises (SME) and small and non-complex credit institutions and captive insurance companies

»Due to the CSRD, the scope of companies that need to report will increase significantly.«

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DIRECTOR PROTIVITI
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WHY IS THE EU DEVELOPING THESE NEW DISCLOSURE REQUIREMENTS?

The European Union monitored the reporting of companies after the introduction of reporting rules by the Non-Financial Reporting Directive (NFRD). It identified several problems: Information seemed to be insufficient as reports omit information that investors and other stakeholders consider important, and comparison and verifiability of the reported information was deemed difficult. These quality issues led to the lack of reliable information and accountability (e.g., for investors to make investment decisions, and for other stakeholders to be informed sufficiently).

In the context of the EU Green Deal, financial market participants are required to disclose detailed information as stated in the Sustainable Finance Disclosure Regulation to serve the aim of the European Union to "re-orient investments towards more sustainable technologies and businesses, finance growth in a sustainable

manner over the long-term, [and] contribute to the creation of a low-carbon, climate resilient and circular economy [1]". However, when companies do not provide the relevant disclosure in an adequate, reliable, timely manner, the basis for the information is not sufficient. As a result, driving improvement of companies' disclosures has become a key initiative of the EU CSRD and the corresponding ESRS.

WHO HAS TO REPORT ACCORDING TO CSRD AND ESRS?

Due to the CSRD, the scope of companies that need to report will increase significantly from today around 12.000 organizations to around 50.000 organizations. All companies listed on an EU-regulated market are covered by the new reporting requirement, except micro-entities. In addition to the listed companies, companies that meet two of the three following criteria must also report with the CSRD

- > 250 employees,
- > €40M turnover,
- > €20M total assets.

These companies are also responsible for assessing the information at the level of their subsidiaries. Further, non-EU companies which have net sales >€150M in the EU and have at least one subsidiary or branch in the EU must report as well.

WHEN DOES THE DETAILED SUSTAINABILITY INFORMATION NEED TO BE REPORTED?

The implementation of the reporting requirements is being staggered as follows:

- **FY 2024** for companies subject to the NFRD
- **FY 2025** for companies which are not subject to the NFRD but meet the criteria as defined above
- **FY 2026** for listed SME and small non-complex credit institutions and active insurance companies
- **FY 2028** for non-EU companies with EU branches or EU subsidiaries
- **OPT-OUT-POSSIBILITY** for capital market-oriented SMEs: Use of a two-year transition period, i.e. first-time application possible in FY 2028

THE DEVELOPMENT OF THE CSRD AND ESRS

The CSRD is an amendment to the previous directive on non-financial disclosures (Directive 2014/95/EU also known as NFRD), which requires certain large companies to disclose relevant non-financial information [2] and sets the framework for the required reporting. The CSRD will create standardization in terms of topics covered and requires reporting on a significantly increased level of detail compared to previous standards. Further, all organizations that must comply with the CSRD need to include the Sustainable Finance's EU taxonomy information on taxonomy aligned turnover, CapEx, and OpEx.

In addition, the ESRS developed by the European Financial Reporting Agency (EFRAG), constitutes the detailed requirements that reporting users in scope have to fulfill in all its details. Until now, sustainability reporting, also known as non-financial reporting, left considerable room for interpretation by the reporting organizations. This will be replaced by strict definitions and detailed reporting requirements of companies including pre-defined KPIs. On behalf of the European Commission, EFRAG is developing the ESRS in collaboration with the Global Reporting Initiative (GRI), Shift and the Task Force on Climate-related Financial Disclosures (TCFD), including defined KPIs for all aspects of ESG. In this context, the EFRAG launched a public consultation on the basis of the Exposure Drafts (EDs), of the first set of sector-agnostic standards as part of the ESRS [3]. A broad spectrum of stakeholders responded to the public consultation. The EFRAG Sustainability Reporting Board adopted the first set of the ESRS standards and handed it over to the EU Commission. After final review, the Commission will adopt the ESRS drafts as delegated act. Then companies in scope of the CSRD are expected to apply them. The standards are expected to be adopted by the European Commission by 30 June 2023.

RELATIONSHIP OF CSRD AND ESRS TO OTHER SUSTAINABILITY/ESG REPORTING STANDARDS

To create a common platform for sustainability reporting, EFRAG's drafts seek compatibility with other international initiatives such as the Task Force on Climate-related Financial Disclosures (TCFD) and Global Reporting Initiative (GRI). Europe is not the only place where sustainability reporting improvements are under way.

The U.S. Securities and Exchange Commission (SEC) has issued a proposal for the disclosure of climate-related information for consultation, with a final rule expected in the latter part of this year. Further, at the end of March 2022, the International Sustainability Board (ISSB) [4] published two exposure drafts for the disclosure of sustainability and climate-related information for consultation with the aim of creating future global minimum standards for sustainability reporting. The feedback received in the 120-day consultation period is currently being reviewed, with a goal to issue the new standards by the end of the year.

STRUCTURE OF ESRS (BASED ON DRAFT DATED NOVEMBER 2022)

The ESRS stipulates standardized disclosure requirements that apply to all organizations (sector-agnostic layer) and requirements that apply to organization active in one or more specific sectors (sector-specific layer). In addition, the ESRS stipulates that an undertaking, as organizations are named in the drafts, shall disclose additional entity-specific information. [5]

The current consultation covers 12 sector-agnostic standards. These standards are split between two cross-cutting standards covering principles and disclosures and ten topic-specific standards (five for environmental issues, four for social, and one for governance). These standards are mandatory for all organizations.

The topic-specific ESRS contain a large number of reporting requirements, which are specified and expanded through application guidance. While many different topics are covered, the topic-specific ESRS generally have the following consistent reporting area structure:

- **GOVERNANCE:** the governance processes, controls and procedures used to monitor and manage impacts, risks and opportunities
- **STRATEGY:** how the undertaking's strategy and business model(s) interact with its material impacts, risks and opportunities, including the strategy for addressing them
- **IMPACT, RISK AND OPPORTUNITY MANAGEMENT:** the process(es) by which impacts, risks and opportunities are identified, assessed and managed through policies and actions
- **METRICS AND TARGETS:** how the undertaking measures its performance, including progress towards the targets it has set [6]

AT A GLANCE: OVERVIEW OF ESRS STANDARDS?

The published ESRS draft requires undertakings to disclose information on the following sustainability matters:

Cross-cutting standards

ESRS 1 General Requirements

Concepts and principles underlying the preparation and presentation of sustainability reports in the management report.

ESRS 2 General Disclosures*

Description of the cross-topic reporting requirements. Those disclosures can be grouped into those that are: (a) of a general nature; (b) on the strategy and business model of the undertaking; (c) on its governance in relation to sustainability; and (d) on its materiality assessment of sustainability impacts, risks and opportunities [7].

Environmental

ESRS E1 Climate Change*

Information on the impact of the undertaking's activities on climate change (positive and negative). Mitigation efforts in line with the Paris Agreement and limiting global warming to 1.5°C. Plans and capacity of the undertaking to adapt its business model(s) and operations in line with the transition to a sustainable economy and to contribute to limiting global warming to 1.5°C.

ESRS E2 Pollution

Information on the impact of the undertaking's activities on pollution of air, water, soil, living organisms, food resources. Information on measures taken to protect the environment.

ESRS E3

Water and Marine Resources

Information on the impact of the undertaking's activities on water, marine resources, and the oceans (incl. protection measures, water use, wastewater, etc.).

ESRS E4

Biodiversity and Ecosystems

Information on the impact of the organization's effects on biodiversity and ecosystem. Information on the contribution of the undertaking's activities to the goals of the EU Green Deal (in particular the EU Biodiversity Strategy 2030), the UN Sustainable Development Goals (Goals 12, 14 and 15), the Post-2020 Global Biodiversity Framework and the consideration of planetary/ecological boundaries.

ESRS E5 Resource Use and Circular Economy

Information on the impact of the undertaking's activities on resource consumption, including the depletion of non-renewable resources and the regeneration of renewable resources. Information on measures to decouple resource consumption and growth.

Social

ESRS S1 Own Workforce**

Information on the impact of the undertaking's activities on its own workforce in terms of working conditions, equal opportunities, and other employee rights.

ESRS S2

Workers in the Value Chain

Information on the impact of the undertaking's activities on employees in the value chain (own, upstream, and downstream activities), including its products and services, its business relationships and its supply chain.

ESRS S3 Affected Communities

Information on the impact of the undertaking's activities on local communities in the undertaking's value chain (own, upstream, and downstream).

ESRS S4 Consumers and End Users

Information on the impact of the undertaking's activities/products or services for consumers and end users.

Governance

ESRS G1 Business Conduct

Information about the undertaking's strategy, approach, processes and procedures, and the undertaking's performance with regard to business conduct (e.g., prevention of corruption, bribery).

* Mandatory disclosure requirement also if it refers to a topic assessed to be not material.

** Selected subtopics of the ESRS S1 are mandatory also if it refers to a topic assessed to be not material, these include S1- 6 Characteristics of the undertaking's employees, S1- 7 Characteristics of non-employee workers in the undertaking's value chain and S1- 8 Collective bargaining coverage and social dialogue; and only for undertakings with 250 or more employees, disclosure requirements (including their datapoints) on policies, actions and targets in ESRS S1 Own workforce.

DOUBLE MATERIALITY AS THE BASIS FOR SUSTAINABILITY/ESG DISCLOSURES

The materiality assessment is not only relevant for the sustainability reporting but is of strategic relevance when it comes to sustainability management and provides a blueprint for the organization's sustainability/ESG strategy. Based on the conviction that a diverse range of stakeholders require sustainability information on an organization's performance the EU follows the principle of double materiality in its reporting standards. Matters must be reported that are material either for the undertaking's financial side [8] or for impact aspects [9] – or for both (outside-in and inside out perspective). [10] All potential material sustainability matters, as pre-defined by ESRS in the sector-agnostic and sector-specific mandated disclosure requirements and entity-specific sustainability matters, must be assessed in the materiality assessment. If the undertaking concludes that a topic is not material and therefore it omits all the Disclosure Requirements in a topical standard, it shall briefly explain the conclusions of its materiality assessment for the topic.

LOCATION OF REPORTING

The CSRD requires that the sustainability reporting is part of the (combined) management report as a specific section. In addition, the reporting has to be machine-readable. Key figures and information will be transmitted and published in a standardized digital format. For this purpose, the sustainability information must be tagged in accordance with the “European Single Electronic Format” (ESEF).

QUALITY OF DISCLOSURE AND AUDIT REQUIREMENT

To ensure that companies comply with the reporting requirements, an independent auditor or certifier must ensure, and report, that the sustainability information meets the certification standards adopted by the EU. In a first step, limited assurance for the sustainability information is required. Over time, in a “gradual approach from limited to reasonable assurance”, it is foreseen that the EU aims for a “reasonable assurance” for sustainability information as it is the case for financial information. If a reporting undertaking fails to comply with

»The materiality assessment is of strategic relevance when it comes to sustainability management.«

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the obligation to publish the information, official sanctions may be imposed in the form of fines.

CONCLUDING COMMENTS

We are at a crossroads. CSRD and ESRS are introducing new, extensive sustainability/ESG requirements for a larger number of organizations than ever. While being a disclosure instrument, CSRD and ESRS require organizations to work intensely on all aspects of sustainability/ESG, set targets and prepare a strategy supported by a common data management to enable transparency and to reach these targets. Data requirements are clearly defined and are broad both regarding the subjects covered as well as the depth of information needed. At this point, Sustainability/ESG needs to be part of the organization's governance, decision-making and business model, while establishing a high transparency on activities and its results.

There is no time to lose as the planned transitional periods are going to require companies to act quickly in their adoption efforts. The fact that room for interpretation and ways to limit application are significantly limited, the effective disclosure of reliable sustainability information requires a robust sustainability program. Therefore, an efficient, targeted, and timely implementation is indispensable to ensure compliance with the CSRD. To properly prepare your organization, you need to assess your current status and get ready for upcoming requirements. The CSRD is an instrument which aims to improve transparency to help an organization to be more sustainable and have a positive impact on the environment and society. As such, companies should seize the opportunity to be both compliant and impactful.

ABOUT PROTIVITI

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SOURCES

[1] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/overview-sustainable-finance_en; cf. https://ec.europa.eu/commission/presscorner/detail/en/QANDA_21_1806

[2] The NFRD amended Directive 2013/34/EU – also known as the Accounting Directive. On April 21, 2021, the Commission adopted a proposal for a Directive amending Directive 2013/34/EU (annual financial statements), Directive 2004/109/EC (harmonization of transparency requirements), Directive 2006/43/EC (statutory audits of annual accounts and consolidated accounts) and Regulation (EU) No 537/2014 (specific requirements regarding statutory audit of public-interest entities), in relation to corporate sustainability reporting.

[3] The additional sector specific information to be disclosed by the organizations for each sector is determined in the sector-specific ESRS. The current draft ESRS SEC1 Sector classification standard determines 40 sectors and 14 sector groups.

[4] On 3 November 2021, the IFRS (International Financial Reporting Standards Foundation) Foundation Trustees announced the creation of a new standard-setting board—the International Sustainability Standards Board (ISSB). Its intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards. Consolidation started earlier in 2021, when the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) announced their merger to form the Value Reporting Foundation, which was then integrated into the ISSB.

[5] https://efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F2211141505388508%2FDRAFT%20ESRS%201%20General%20requirements%2014%20November_.pdf

[6] <https://efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F2211141505388508%2FDraft%20ESRS%202%20General%20Disclosures%2015%20November%202022.pdf>

[7] <https://efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F2211141505388508%2FDraft%20ESRS%202%20General%20Disclosures%2015%20November%202022.pdf>

[8] A sustainability matter is material from a financial perspective if it triggers or may trigger material financial effects on the undertaking's development, performance, and position in the short-, medium- or long-term. This is the case, in particular, when it generates or may generate risks or opportunities that influence or are likely to influence significantly its future cash flows. https://efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F2211141505388508%2FDRAFT%20ESRS%201%20General%20requirements%2014%20November_.pdf

[9] Impact materiality: A sustainability matter is material from an impact perspective when it pertains to the undertaking's material actual or potential, positive or negative impacts on people or the environment over the short-, medium- or long-term. A material sustainability matter from an impact perspective also includes impacts caused or contributed to by the undertaking and impacts which are directly linked to the undertaking's operations, products, and services through its business relationships. https://efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F2211141505388508%2FDRAFT%20ESRS%201%20General%20requirements%2014%20November_.pdf

[10] In other words, a sustainability matter meets the criteria of double materiality if it is material from either the impact perspective or the financial perspective or both perspectives, states the proposal. The ISSB approach, in contrast, defines materiality from a financial perspective and is primarily aimed at investors. https://efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F2211141505388508%2FDRAFT%20ESRS%201%20General%20requirements%2014%20November_.pdf