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European Union’s Corporate Sustainability Reporting Directive — What Non-EU Companies with Operations in the EU Need to Know

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On November 28, 2022, the European Council formally adopted the Corporate Sustainability Reporting Directive (“CSRD”), following adoption by the European Parliament on November 10, 2022. The CSRD is now due to be signed and published in the European Union (“EU”) Official Journal and will come into force 20 days after publication.[1]

The CSRD will replace and significantly broaden the scope of the existing sustainability reporting requirements under the EU’s current sustainability reporting rules, which are set out in a suite of directives and regulations, including the Non-Financial Reporting Directive[2] (“NFRD”). The NFRD currently requires that “public interest” entities, including large EU listed entities, credit institutions, insurance companies, and other entities designated as such by an EU member state, report certain sustainability information on an annual basis. While still subject to further implementation (as discussed below), the CSRD will also have important implications for non-EU groups with significant EU operations, as it will impose substantive and expanded disclosure requirements on those groups, with a resulting increase in costs. It will also likely lead to increased regulatory complexity and compliance risks.

Overview of the CSRD

The CSRD is intended to revise and strengthen the rules introduced by the NFRD by promoting relevant, comparable, reliable, and accessible sustainability information for investors and stakeholders.[3] The CSRD reporting requirements will complement and be aligned to other key EU sustainable finance initiatives that are directed principally at companies in the financial services and capital markets sectors, including the Sustainable Finance Disclosure Regulation (“SFDR”) (effective as of March 10, 2021)[4] and the EU Taxonomy Regulation (partially effective as of January 1, 2022, and fully effective as of January 1, 2023).[5]

As discussed in detail below, the CSRD will materially broaden the scope of sustainability information disclosed to stakeholders, increase the number of entities required to report such information, and introduce a new limited audit assurance requirement prior to October 1, 2026 and a new reasonable assurance requirement prior to October 1, 2028. The CSRD will apply to all large EU undertakings, both public and private. This expanded scope will apply the CSRD to, among others, U.S. entities with significant EU operations. Under the CSRD, small and medium enterprises (“SMEs”) will have delayed compliance requirements, and micro-undertakings will be excluded from compliance altogether.

Entities Covered by the CSRD and Exemptions

Related People

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Entities covered by the CSRD include:

1. all undertakings with securities listed on EU regulated markets (other than listed micro-undertakings);
2. all "large undertakings" (whether listed or not), being an EU undertaking or an EU subsidiary of a non-EU entity that satisfies at least two of the three following criteria as of the relevant balance sheet date:
    a. a balance sheet total exceeding €20,000,000;
    b. a net turnover[6] exceeding €40,000,000; and
    c. in excess of 250 employees on average during the financial year.
3. all parent undertakings of "large groups" (whether listed or not), being groups which on a consolidated basis satisfy two of the three criteria set out at a. through c. above; and
4. as of January 1, 2026 (with the ability to opt-out until 2028), "small" and "medium-sized enterprises" with transferable securities on an EU regulated market.[7]

Note that certain EU subsidiaries of non-EU entities, as well as any non-EU entities with transferable securities listed on an EU regulated market, accordingly will be subject to the CSRD.

From financial years starting on or after January 1, 2028, the CSRD will also apply to non-EU undertakings (labelled "third country undertakings") that generate a net turnover of more than €150,000,000 in the EU and have: (i) an EU branch office with a net turnover of at least €40,000,000 in the EU; or (ii) a large or listed EU subsidiary.[8] The subsidiary or branch will be responsible for preparing a sustainability report for the third country undertaking at a consolidated level. These sustainability reports will need to be prepared according to: (i) separate standards to be adopted by the European Commission ("Commission") by June 30, 2024; (ii) the standards applicable to EU undertakings; or (iii) standards which are deemed equivalent by the Commission. These sustainability reports of third country undertakings need to be published with an assurance opinion by a firm authorized to give such an opinion under the national law of the third country undertaking or of a member state.

A subsidiary undertaking will be exempt from reporting if that entity and its subsidiaries (if applicable) were included in the consolidated management report of the parent undertaking, provided that the parent's report is compliant with the CSRD. This exemption would also apply where a subsidiary undertaking (and its subsidiaries) were included in the consolidated management report of a non-EU parent undertaking and that parent's sustainability disclosures were determined to be "equivalent" to EU sustainability reporting standards. At this time, there is ambiguity on the equivalence protocol and likely outcomes of allowing non-EU parents to produce compliant consolidated reporting. Because it is not clear how this "equivalence test" will be applied (or indeed which non-EU countries will be treated as having equivalent sustainability reporting standards), non-EU entities must keep abreast of regulatory developments in this regard. While a parent in a non-EU country will be able to voluntarily choose to publish compliant consolidated management reports containing the relevant sustainability information mandated by the CSRD, this will not automatically exempt any of its EU subsidiary undertakings that fall within the scope of the CSRD.

For U.S. companies, the "equivalence" analysis adds another element of regulatory complexity, especially given that the U.S. Securities and Exchange Commission ("SEC") has separately proposed new rules for climate change disclosure requirements for both U.S. public companies and foreign private issuers on March 21, 2022[9] (as discussed in further detail in our webcast here and our previous client alert here). There is no guarantee that those rules or any final SEC sustainability rules will be determined to be "equivalent"

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by the Commission for purposes of CSRD compliance,[10] and notably the proposed SEC rules deal with disclosures only for climate-related matters while disclosures under the CSRD include climate-related matters as well as other ESG-related matters.

For UK groups with substantial European operations, post-Brexit, a similar question will arise in relation to "equivalence". The UK has arguably been leading the global landscape in relation to mandatory climate reporting pursuant to the Task Force on Climate-related Financial Disclosures ("TCFD") and there exists a suite of specific ESG-related reporting requirements (e.g. in relation to modern slavery, consideration of broader stakeholder considerations and gender pay gap information). Nonetheless, the UK has yet to introduce a comprehensive set of mandatory non-climate related reporting requirements of the type envisaged by the CSRD.

As a practical matter, this means that EU large undertakings with non-EU parents could have to report consolidated sustainability information on a subsidiary-by-subsidiary basis if equivalence with the non-EU country's sustainability reporting requirements is not determined. This could have wide-reaching implications for non-EU parent entities with significant subsidiary operations in the EU, not just in relation to the compliance burden of increased reporting costs across multiple entities, but also the compliance challenge and associated risks of ensuring relevance, accuracy and consistency across multiple reports.

Scope of Matters to be Reported and Relevant Reporting Standards

The CSRD will require reporting of forward-looking, retrospective, qualitative and quantitative information necessary to understand an undertaking's ***impacts on sustainability matters*** and, from the "opposite" lens, the information necessary to understand ***how sustainability matters affect an undertaking's development, performance, and position*** (i.e., "double materiality" reporting). The principle of double materiality requires that entities look inward to evaluate how sustainability issues affect the entity and look outward to understand how the entity impacts people and the environment.

The CSRD clarifies that entities will need to report on both elements of materiality for compliance with the reporting requirements. In particular, CSRD reporting entities will need to disclose:[11]

1. ***Strategy***: Their business model and strategy, including:

    the resilience of their business model and strategy to risks related to sustainability matters;

    their opportunities related to sustainability matters;

    their plans to ensure that their business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5°C in line with the Paris Agreement and the objective of achieving climate neutrality by 2050;

    their business model and strategy take account of the interests of their stakeholders and of their impact on sustainability matters; and

    how their strategy has been implemented with regard to sustainability matters.

2. ***Targets***: The sustainability targets set and the progress made towards achieving them.
3. ***Governance***: The role of the administrative, management and governance bodies in relation to sustainability factors.
4. ***Policies***: Their policies in relation to sustainability matters.
5. ***Incentives***: Information about the existence of sustainability-linked incentive

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schemes offered to members of the administrative, management and supervisory bodies.

6. ***Due Diligence***: The due diligence process implemented with regard to sustainability matters.
7. ***Impacts***: Their most significant negative impacts on sustainability factors.
8. ***Remedial Actions***: Any actions taken, and the results of such actions, to prevent, mitigate, remediate or bring an end to actual or potential adverse impacts.
9. ***Risks***: Their principal risks related to sustainability matters, including their principal dependencies on such matters, and how those risks are managed.
10. ***Reporting Scope***: The manner in which they identified the information on which the report.

Time horizons: The CSRD will also require that qualitative and quantitative, forward-looking and retrospective information be disclosed, taking into account short, medium and long-term time horizons.

Value chains: Where appropriate, undertakings will also be required to disclose information regarding their own operations as well as their value chains, including products and services, business relationships and supply chains.

Sustainability Standards: Disclosures will need to be reported in accordance with the European Sustainability Reporting Standards ("ESRS") currently being developed by the European Financial Reporting Advisory Group ("EFRAG"), a public-private partnership tasked to advise the Commission on the adoption of international financial reporting standards into EU law. By June 30, 2023, the Commission must adopt the first set of standards and by June 30, 2024, the Commission must adopt further complementary information requirements with regards to sustainability matters, separate standards for third country undertakings and SMEs, and sector-specific standards.[12] The Commission has noted that sector-specific standards are particularly important for sectors associated with high sustainability risks and/or impacts on the environment, human rights and governance.

The standards are required to specify the information that should be disclosed regarding the following sustainability matters:

- ***Environmental:*** (i) climate change mitigation; (ii) climate change adaptation; (iii) water and marine resources; (iv) resource use and circular economy; (v) pollution; and (vi) biodiversity and ecosystems (with reference to natural capital accounting to effectively monetize and quantify the cost/benefit of natural resources);
- ***Social:*** (i) equal treatment and opportunities, including gender equality and equal pay for equal work, training and skills development, employment and inclusion of people with disabilities, measures against violence and harassment in the workplace, and diversity; (ii) working conditions, including secure employment, working time, adequate wages, social dialogue, freedom of association, existence of work councils, collective bargaining, the information, consultation and participation rights of workers, work-life balance and health and safety; and (iii) respect for human rights, fundamental freedoms, democratic principles and standards established in the International Bill of Human Rights and other core UN human rights conventions, the International Labor Organization's Declaration on Fundamental Principles and Rights at Work and the ILO fundamental conventions, the European Convention of Human Rights, the revised European Social Charter, and the Charter of Fundamental Rights of the European Union; and
- ***Governance:*** (i) the role of the undertaking's administrative, management and supervisory bodies with regard to sustainability matters, and their composition, and their expertise and skills to fulfil this role or access to such expertise and skills; (ii)

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> the main features of the undertaking's internal control and risk management systems in relation to the sustainability reporting process; (iii) business ethics and corporate culture, including anticorruption and anti-bribery, the protection of whistle-blowers and animal welfare; (iv) engagement of the undertaking to exert its political influence, including its lobbying activities; (v) the management and quality of relationships with customers, suppliers and communities affected by the activities of the undertaking, including payment practices, especially with regard to late payment to SMEs; and (vi) the main features of the undertaking's internal control and risk management systems, in relation to the sustainability reporting and decision-making process.

While the Commission has flagged the need for the standards to be consistent with other European legislation (i.e., EU Taxonomy Regulation and SFDR), the proposal does not point towards any one international standard or framework as a model or foundation. Instead, the proposal refers to the broad objective of taking into account existing standards and frameworks such as the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board, TCFD, the Climate Disclosure Standards Board, International Integrated Reporting Council, International Accounting Standards Board and any standards developed under the auspices of the IFRS Foundation.[13]

Audit Assurance: To help prevent greenwashing, the CSRD will also introduce a general EU-wide audit assurance requirement for reported sustainability information.[14] Previously, under the NFRD, audit assurance was optional. Under the CSRD, the Commission must adopt legislation to provide for a "limited assurance" requirement by October 1, 2026, and subsequently adopt further legislation to provide for a higher "reasonable assurance" requirement by October 1, 2028. EU member states will have the power to authorize independent assurance service providers to carry out this sustainability assurance work, which will broaden the choice of assurance providers beyond statutory auditors or audit firms.

Where to Report and Format of Reporting

The CSRD requires sustainability information to be published in an entity's management report and not a separate, standalone report. To aid in the access, review, and comparability of sustainability information, the financial statements and management reports of CSRD reporting entities will be required to be published in a digital file format. Note that U.S. entities will likely include the management report as part of the Annual Report on Form 10-K since a separate, standalone ESG report will not comply with the CSRD.

CSRD Regulatory Approval Process

In connection with the CSRD rulemaking, the Commission carried out an Impact Assessment, including a public consultation. On April 21, 2021, the Commission adopted a proposal for the CSRD, and the proposal was open for public feedback until July 14, 2021. On June 21, 2022, the member states in the European Council and the European Parliament reached a provisional political agreement on the CSRD. On November 10, 2022, The European Parliament adopted a final legislative text based on the Commission's proposal on November 10, 2022, which was then adopted by the European Council on November 28, 2022. The CSRD is now due to be signed by the President of the European Parliament and the President of the European Council, after which it will be published in the EU Official Journal, and enter into force 20 days thereafter. Following this, member states must incorporate the CSRD into their local law within 18 months.[15]

In parallel, EFRAG set up a task force to lead the development of the sustainability standards applicable under the CSRD – the Project Task Force Non-Financial Reporting Standards ("PTF-NFRS"). The PTF-NFRS published a report in March 2021 outlining its proposed roadmap for development of a comprehensive set of EU sustainability standards. Elaboration of draft standards in project mode commenced in June 2021 and,

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significantly, on July 8, 2021, the EFRAG task force announced a Statement of Cooperation with the GRI. The GRI standards are currently the most commonly used sustainability reporting standards amongst EU entities.

EFRAG launched a public consultation on the ESRS exposure drafts in April 2022, with the consultation period closing on August 8, 2022. These exposure drafts corresponded to the first set of standards required under the CSRD and covered environmental, social and governance matters (described as "topical" standards) as well as cross-cutting standards (such as general principles, strategy, governance and materiality assessment disclosure requirements). On November 22, 2022, EFRAG submitted a set of twelve draft ESRS to the Commission, which take into consideration the results of the public consultation. The Commission will now consult with other EU bodies and member states on the draft ESRS, and is expected to adopt a set of final standards in June 2023. EFRAG is expected to release a second set of draft ESRS in the coming months, with a focus on sector-specific and SME standards.

The CSRD will apply to entities that are already subject to NFRD for financial years starting on or after January 1, 2024 with the new disclosures therefore appearing in reports published in 2025. In scope entities that are not already subject to NFRD will be required to apply CSRD for financial years starting on or after January 1, 2025. Reporting will be delayed for SMEs whose securities are admitted to trading on an EU regulated market until financial years starting on or after January 1, 2026 (subject to an opt-out until 2028) and for third country undertakings until financial years starting on or after January 1, 2028.[16]

Note that once adopted, the CSRD requires member state implementation into local law. Thus, it is possible that there may be divergences on both the timing of implementation and the approach between member states.

Key Takeaways

The reporting obligations arising from the CSRD are significant compared to the NFRD. In addition, the CSRD's scope is much broader given the breadth and relative sizes of many U.S., UK and non-EU entities with significant operations in various EU jurisdictions. As a result, the CSRD may lead to a marked increase in additional substantive disclosures (and increased costs), including multiple subsidiary-level reporting obligations, and the associated risks of divergent reporting. With the CSRD's adoption, the SEC's proposed expanded climate change requirements in the U.S., and the UK Government and relevant agencies rolling out mandatory TCFD-aligned climate disclosure requirements while also pushing for enhanced non-climate related disclosures, it will be important for U.S. and UK companies with significant EU operations to start compiling and developing standards and procedures to confirm the accuracy of sustainability information.

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[1] Council of the European Union, Press Release, Council gives final green light to corporate sustainability reporting directive (November 28, 2022), available at https://www.consilium.europa.eu/en/press/press-releases/2022/11/28/council-gives-final-green-light-to-corporate-sustainability-reporting-directive/.

[2] The key rules and regulations are set out in the Accounting Directive (Directive 2013/34/EU) (which was amended by the NFRD), the Transparency Directive (Directive 2004/109/EC), the Audit Directive (2006/43/EC) and the Audit Regulation (Regulation (EU) 537/2014.

[3] Executive Summary of the Impact Assessment, European Commission (April 21, 2021), available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021SC0151&from=EN .

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[4] The SFDR complements corporate disclosures by providing a comprehensive reporting framework for financial products and financial entities. FAQ: what is the EU Taxonomy and how will it work in practice?, European Commission, (April 21, 2021) at page 3, available here.

[5] The EU Taxonomy Regulation is a green classification system that translates the EU's climate and environmental objectives into criteria for specific economic activities for investment purposes and provides a common understanding of economic activities that make a substantial contribution to the EU's environmental goals. *Id* at page 1.

[6] The definition of "net turnover" is "the amounts derived from the sale of products and the provision of services after deducting sales rebates and value added tax and other taxes directly linked to turnover" as defined in the Accounting Directive (see footnote 2 above).

[7] Listed micro-undertakings (those that do not satisfy two of the three following criteria: (i) a balance sheet total exceeding €350,000; (ii) a net turnover exceeding €700,000; and (iii) in excess of ten employees) will be exempt from the CSRD.

[8] Corporate Sustainability Reporting Directive (November 10, 2022), at point (14) of Article 1 (introducing Article 40a to the Accounting Directive) and point (2) of Article 5, available at https://www.europarl.europa.eu/doceo/document/TA-9-2022-0380_EN.pdf

[9] Securities and Exchange Commission, The Enhancement and Standardization of Climate-Related Disclosures for Investors, available at https://www.sec.gov/rules/proposed/2022/33-11042.pdf.

[10] "Equivalence" will be determined pursuant to the formal mechanisms established by the European Commission as envisaged under Article 23(4)(i) of Directive 2004/109/EC, available here.

[11] Corporate Sustainability Reporting Directive (November 10, 2022), at point (4) of Article 1 (replacing Article 19a of the Accounting Directive), available at https://www.europarl.europa.eu/doceo/document/TA-9-2022-0380_EN.pdf.

[12] *Id.* at point (8) of Article 1 (inserting Articles 29b and 29c into the Accounting Directive) and point (14) of Article 1 (inserting Article 40b into the Accounting Directive).

[13] In March 2021 the IFRS Foundation announced creation of a working group to accelerate convergence in global sustainability reporting standards focused on enterprise value and to undertake technical preparation for a potential international sustainability reporting standards board under the governance of the IFRS Foundation. Press Release, IFRS, IFRS Foundation Trustees announce working group to accelerate convergence in global sustainability reporting standards focused on enterprise value (March 22, 2021), available here.

[14] Corporate Sustainability Reporting Directive (November 10, 2022), at point (13) of Article 1 (amending Article 34 of the Accounting Directive), available at https://www.europarl.europa.eu/doceo/document/TA-9-2022-0380_EN.pdf.

[15] *Id.* at point (1) of Article 5.

[16] *Id.* at point (2) of Article 5.

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Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have about these developments. To learn more about these issues, please

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