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EUROPEAN CORPORATE SUSTAINABILITY REPORTING DIRECTIVE (CSRD): KEY TAKEAWAYS FROM ADOPTION OF THE EUROPEAN SUSTAINABILITY REPORTING STANDARDS

To Our Clients and Friends:

On July 31, 2023, the European Commission (the "Commission") adopted the first set[1] of European Sustainability Reporting Standards (the "ESRSs")[2] for use by all entities subject to the Corporate Sustainability Reporting Directive (the "CSRD")[3]. The ESRSs are now subject to a two month scrutiny period (extendable by up to two months), during which the European Parliament and the Council of the European Union ("EU") may approve (in its entirety) or reject the ESRSs. If approved, the ESRSs will apply, in the first instance, to companies that are already subject to the EU's non-financial reporting framework (based on the Non-Financial Reporting Directive (the "NFRD")[4]) for reporting periods beginning January 1, 2024: namely, so-called "large" EU undertakings exceeding an average of 500 employees during the financial year that either have securities admitted to an EU-regulated market or are regulated financial entities (*e.g.*, banks or insurance companies). The CSRD and the ESRSs will be phased-in for other categories of entities, including companies outside the EU, over the next five years.

The ESRSs now provide a detailed basis for in-scope entities to begin to assess their potential reporting obligations, including assessing which aspects are material under the new, broad "double materiality" standard of the CSRD, looking both at the impact of the company (inside-out) as well as the financial impact on the company (outside-in). Such analysis will allow companies to undertake the requisite due diligence on material topics and integrate changes to their reporting process. Effective implementation will require substantial resources and a thorough analysis of the ESRSs and the CSRD reporting obligations resulting thereof.

In this alert, we provide context and an overview of the 12 standards in the first set of ESRSs, along with a review of key changes as compared to earlier ESRSs drafts.

Background

The CSRD came into force on January 5, 2023, and the Commission mandates that each EU member state implement the CSRD into national law by July 6, 2024. The CSRD extends the scope of non-financial reporting under the NFRD to include sustainability reporting and requires such disclosures from an expanded range of entities, including large companies, listed small and medium-sized companies ("SMEs") and even non-EU parent companies of such in-scope companies, and certain branches. The NFRD's requirements remain in force until companies have to comply with the national laws implementing the CSRD. More detailed discussions of the CSRD, including its impact for non-EU entities with a significant presence in the EU, can be found in our client alert available here.

The CSRD, as a directive, requires the Commission to develop standards for what a reporting entity must disclose about its material impacts, risks and opportunities in relation to certain environmental, social and governance ("ESG") matters. In accordance with the CSRD, the ESRSs are based on draft standards developed by EFRAG (previously known as the European Financial Reporting Advisory Group), a non-profit organization dedicated to the advancement and advocacy of European perspectives in financial and sustainability reporting.

EFRAG submitted its first draft ESRSs to the Commission on November 22, 2022 (the "Draft ESRSs").[5] The Draft ESRSs were developed based on input that EFRAG had received from public consultation on exposure drafts of the ESRSs developed from April to August 2022.[6] Following EFRAG's submission of the Draft ESRSs, the Commission carried out further consultations leading to the publication for consultation of the first set of Draft ESRSs for a four-week public feedback period from June 9 to July 7, 2023.

The consultation process confirmed that the Draft ESRSs broadly met the CSRD's mandate. However, various stakeholders drew attention to potential issues with the Draft ESRSs, including the challenging nature of disclosure requirements against a backdrop of limited primary source data and the lack of coherence between disclosures under the ESRSs and the disclosure obligations under other European regulations including the Sustainable Finance Disclosure Regulation or 'SFDR,' the Benchmarks Regulation and the Capital Requirements Regulation (cumulatively, the "Financial Regulations").[7]

The Commission made a number of modifications to the Draft ESRSs in response to this feedback. The Commission published and adopted their final version of the ESRSs on July 31, 2023.

Overview of First Set of ESRSs

The first 12 standards in the ESRSs include two "cross-cutting" standards that apply across all ESG topics and 10 topical standards divided across ESG matters. Compared to the Draft ESRSs, the final set of ESRSs reflect a reduction in both the number of disclosure requirements (from 136 to 84) and the number of qualitative and quantitative data points (from 2,161 to 1,144).

"Cross-Cutting" Standards

ESRS 1 General Requirements

ESRS 2 General Disclosure

Environmental Standards

ESRS E1 Climate Change

ESRS E2 Pollution

ESRS E3 Water and Marine Resources

ESRS E4 Biodiversity and Ecosystems

ESRS E5 Resource Use and Circular Economy

Social Standards

ESRS S1 Own Workforce

ESRS S2 Workers in the Value Chain

ESRS S3 Affected Communities

ESRS S4 Consumers and End-Users

Governance Standards

ESRS G1 Business conduct

The ESRSs include descriptions of the disclosure requirements under each standard. For example, for the disclosure requirement related to ESRS 2's integration of sustainability-related performance in incentive schemes, the ESRSs state that reporting entities shall disclose whether and how climate-related considerations are factored into the renumeration of members of the administrative, management and supervisory bodies, including any assessment against GHG emissions reductions targets.

Another example includes the disclosure requirements under ESRS E1's transition plan for climate change mitigation. The ESRSs instruct reporting entities to disclose their transition plans, including explanations of how it's targets are compatible with the limiting of global warming to 1.5°C in line with the Paris Agreement and explanations of the decarbonization levers identified, and key actions planned, including changes in the reporting entity's product and service portfolio and the adoption of new technologies in its own operations, or the upstream and/or downstream value chain.

Key Changes from the Draft ESRSs

The Commission received 604 comments and pieces of feedback on the Draft ESRSs. The top five categories of respondents were companies (26.66%), business associations (24.17%), non-governmental organizations ("NGOs") (14.07%), EU citizens (13.25%) and others (10.60%) and the top five countries where respondents provided feedback were Germany (18%), Belgium (17%), Netherlands (13%), France (10%) and the United Kingdom (5%).[8]

The Commission responded to stakeholder feedback with the following modifications in the ESRSs:[9]

Most Disclosures Limited by Materiality (But Double Materiality Standard Retained)

The Draft ESRSs would have required companies to report on the following standards regardless of whether they were material to their business: the "Climate Change" standard (ESRS E1), certain data points under the "Own Workforce" standard (ESRS S1) for companies with more than 250 employees, and certain data points that correspond to information required by the Financial Regulations.

The ESRSs will now only mandate that all reporting companies to address the "General Disclosure" standard (ESRS 2). Otherwise, all other standards, disclosure requirements and data points must only be disclosed if they are assessed to be material[10] to the company.

The Commission expects these changes will lessen the burden of implementing and complying with the ESRSs by requiring companies to focus on those ESG impacts, risks and opportunities that are material.[11] However, companies should not underestimate the potential reporting burden and compliance costs presented by this approach. The ESRSs' "double materiality" standard for assessing materiality (taken from the CSRD) represents for many reporting entities, a significant departure from the investment-decision-based or financial materiality tests under U.S. securities law and other reporting standards.

Double materiality assesses matters from two perspectives: (1) an 'inside-out' impact perspective, meaning a company's actual or potential impact on people or the environment; and (2) an 'outside-in' financial perspective, meaning how social and environmental issues create financial risks and opportunities for the company. Matters that are material under one or both of these standards must be disclosed. Notably, companies will not be making these determinations in a vacuum, as materiality assessments are subject to external, third-party assurance in accordance with the CSRD.[12] When certain matters are determined to be immaterial, the company must also affirmatively state that determination and its analysis in its reports.

For example, a reporting entity is required to provide a thorough explanation if it concludes that the "Climate Change" standard (ESRS E1) is not a material topic for its business. In a similar vein, if a reporting entity concludes that a certain data point corresponding to information required by the Financial Regulations is not material, it must explicitly state that the data point is "not material." The ESRSs also indicate that reporting entities should include a table in their disclosures with all such data points, with either the location of the data point in the report or stating it is "not material," as applicable.

The Commission asked EFRAG to prepare additional guidance on the ESRSs for reporting entities, including on the materiality assessment.[13] During its August 23, 2023 public session, EFRAG will provide an update on the first draft "EFRAG Implementation Guidance and FAQ" regarding the materiality assessment and value chain. In addition, EFRAG will consider responses from the Commission's four-week public feedback period on the Draft ESRSs to identify priority areas for further guidance. EFRAG will also soon have a place on its website for stakeholders to submit ESRSs application questions.[14]

Additional Phase-In Requirements

The Commission included further phase-ins, in addition to those provided in the Draft ESRSs, to support applicable reporting entities in transitioning from existing methodologies or frameworks to the ESRSs. Under these phase-ins:

- Reporting entities with fewer than 750 employees may omit:
  - for *its first year* of applying the ESRSs - Scope 3 GHG emissions data (included in ESRS E1) and the disclosure requirements specified in the "Own Workforce" standard (ESRS S1), and
  - for *its first two years* of applying the ESRSs - the requirements in the standards on Biodiversity and Ecosystems (ESRS E4), Workers in the Value Chain (ESRS S2), Affected Communities (ESRS S3) and Consumers and End-Users (ESRS S4).
- All reporting entities (regardless of the number of employees) may omit, *for the first year* of applying the ESRSs:
  - financial effects related to non-climate environmental issues, such as Pollution (ESRS E2), Water (ESRS E2), Biodiversity (ESRS E4) and Resource Use (ESRS E5), and
  - certain data points related to their own workforce (ESRS S1) (social protection, persons with disabilities, work-related ill-health, and work-life balance).

Desired Interoperability with Global Standard Setting Initiatives

Comments to the Draft ESRSs raised concerns that the standards would not be consistent with the EU's sustainability ambitions and other pieces of sustainability legislation, and did not ensure the interoperability of global standards such that companies could use the same sustainability-related information for multiple legislations or standards. The Commission noted that it worked to ensure a "very high degree of interoperability" among the ESRSs, the global reporting framework under development by the International Sustainability Standards Board (the "ISSB") and the Global Reporting Initiative ("GRI"). The ESRSs were also created in parallel with the first two standards under the ISSB, IFRS S1 and IFRS S2, which were published on June 26, 2023. The Commission, EFRAG and the ISSB discussed the standards at length in an effort to provide a high degree of alignment where the standards overlap. For example, companies that are required to disclose under the requirements of the "Climate Change" standard (ESRS E1) of the ESRSs are expected, to a large degree, to be able to report the same information under the ISSB climate-related disclosures (IFRS S1).

While the ESRSs and the ISSB standards are built on existing reporting frameworks, including the Task Force on Climate-Related Financial Disclosures ("TCFD")[15], it is important to note that the ESRSs and the ISSB requirements are <u>not</u> interchangeable, so if and when the ISSB Sustainability Standards come to be adopted by national regulators, reporting entities will need to review each set of standards to confirm that all requirements are being applied and met.

The ESRSs' anticipated adoption of the CSRD's double materiality standard[16] is a principal area of divergence from the ISSB's financial materiality standard. While the ESRSs use the broad double materiality standard discussed above, the ISSB standard is modeled on the financial materiality standard used by the IFRS international accounting standards: that information is material if its omission, obfuscation or misstatement could be reasonably expected to impact investor decisions. This reflects in part the purpose of each standard. ISSB intends to address the needs of financial stakeholders (e.g., investors and lenders) for a global ESG reporting framework while the CSRD and ESRSs intend to address the needs of a broader range of stakeholders, including investors, NGOs, trade unions, civil society organizations, consumers, community and value chain and indeed when undertaking their materiality assessment for CSRD purposes, reporting entities are required to consult with their broader base of stakeholders.

EFRAG has created a TCFD recommendations and Draft ESRSs reconciliation table and they are working on a mapping table that includes requirements for each of the ESRSs and the ISSB standards. The TCFD/ESRSs reconciliation table and the draft version of the ESRSs/ISSB table are available on their website.

Expanded Voluntary Disclosures and Further Reporting Options

Although the Draft ESRSs included several voluntary data points, the Commission included even more in the ESRSs by converting a limited number of reporting requirements from mandatory to voluntary. These modifications included, for example, biodiversity transition plans, specific indicators related to "non-employees" in the reporting entity's own workforce and an explanation as to why a particular sustainability topic is not material.

The Commission also introduced certain flexibilities for disclosure against some mandatory data points instead of converting them to voluntary data points. For example, there are additional flexibilities in the disclosure requirements on the financial effects stemming from sustainability risks and engagement with stakeholders, as well as in the methodology used for the materiality assessment process.[17] Furthermore, the Commission modified the data points concerning corruption and bribery, as well as the protection of whistle-blowers, which the Commission was concerned could be perceived as impairing the right to refrain from self-incrimination.[18]

Final Approval Pending

In the second half of August 2023, the ESRSs will be formally transmitted to the European Parliament and to the Council of the EU for a two month scrutiny period (extendable by up to two months). The European Parliament and the Council of the EU may approve (in its entirety) or reject the ESRSs, but neither can amend it. If approved by the European Parliament and the Council of the EU, the ESRSs may apply for some companies as early as January 1, 2024 (for reporting in 2025).

Reporting obligations for in scope companies begin as early as the 2024 reporting period. Companies or reporting entities that fall within the scope of the CSRD need to review these standards to begin assessing potential reporting obligations and compliance costs.

What's Next

In the ESRSs, the Commission responded to feedback and reduced the weight of the reporting burden by allowing reporting entities to focus more on meaningful materiality assessments and the quality of disclosures. However, the ESRSs have received a mix reception from the market. Various stakeholder groups, including some groups of investors[19], have bemoaned the dilution introduced by the Commission in the ESRSs. Despite these complaints, it is expected that stakeholders will benefit in the mid-longer term if material reliable disclosures are made by reporting entities.

In addition to developing guidance to support companies disclosing against the standards, EFRAG has been tasked with developing sector-specific standards. First drafts of standards for eight sectors are already up and running. The CSRD requires the Commission to adopt additional sets of ESRSs by June 2024, including at least eight sector-specific standards, proportionate standards for listed SMEs and standards for non-EU companies. EFRAG is currently developing draft sector-specific standards from the following sectors: (1) Oil and Gas, (2) Coal, Quarries and Mining, (3) Road Transport, (4) Agriculture Farming and Fisheries, (5) Motor Vehicles, (6) Energy Production and Utilities, (7) Good and Beverages and (8) Textiles, Accessories, Footwear and Jewelry. Any decisions taken to start new sector work will be published on EFRAG's website.[20] The final work stream in relation to the development of standards will be the formation of specific standards for reporting at the level of non-EU company parent companies, which will commence for financial year 2028 (for reporting in 2029).

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[1] The CSRD requires the Commission to adopt a second set of sustainability reporting standards by June 30, 2024, specifying sector-specific standards, standards for small and medium sized enterprises and to take account of the development of international standards.

[2] Commission Delegated Regulation supplementing Directive 2013/34/EU as regards sustainability reporting standards (available here), including Annex 1 (available here) and Annex 2 (available here).

[3] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, available here.

[4] Accounting Directive by Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, available here.

[5] Draft Commission Delegated Regulation supplementing Directive 2013/34/EU as regards sustainability reporting standards (available here), including Draft Annex 1 and Draft Annex 2.

[6] Exposure drafts of the ESRSs are published on EFRAG's website, available here.

[7] All comments and feedback on the Draft ESRSs are published on the European Commission website, available here.

[8] The European Commission, Total of valid feedback instances received: 604, available at https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13765-European-sustainability-reporting-standards-first-set/feedback_en?p_id=32180832.

[9] Additional information can be found in our client alert "European Union's Corporate Sustainability Reporting Directive — What Non-EU Companies with Operations in the EU Need to Know," accessible at the following link.

[10] EFRAG is developing additional guidance on the materiality assessment, the process to determine material matters and material information. Additional information is below.

[11] Commission Delegated Regulation (EU) of 31.7.2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards, Article 2, available at http://ec.europa.eu/finance/docs/level-2-measures/csrd-delegated-act-2023-5303_en.pdf.

[12] Under the CSRD, the Commission must adopt legislation requiring independent assurance of sustainability reports and metrics by a third-party auditor. This has the goal of raising the quality of sustainability reporting to the same level as financial reporting. *See* Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, starting at point sixty (60) of Article 1, available here.

[13] Commission Delegated Regulation (EU) of 31.7.2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards, Article 2, available at http://ec.europa.eu/finance/docs/level-2-measures/csrd-delegated-act-2023-5303_en.pdf.

[14] EFRAG, Press Release, EFRAG Welcomes the Adoption of the Delegated Act on the First Set of European Sustainability Reporting Standards (ESRS) by the European Commission(July 31, 2023), available at efrag.org/News/Public-439/EFRAG-welcomes-the-adoption-of-the-Delegated-Act-on-the-first-set-of-E.

Sustainability Reporting Standards, EFRAG Sector Specific ESRS, available at https://www.efrag.org/lab5.

[15] In addition to the TCFD, the ESRSs and ISSB standards are built on existing frameworks from the Sustainability Accounting Standards Board (SASB) and Climate Disclosure Standards Board (CDSB).

[16] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, at point twenty-nine (29) of Article 1, available here.

[17] An example of the additional flexibilities is included in General Disclosure (ESRS 2): disclosure of "the undertaking's understanding of the interests and views of its key stakeholders" –"key" added.

[18] Commission Delegated Regulation (EU) of 31.7.2023 supplementing Directive 2013/34/EU of the European Parliament and of the Council as regards sustainability reporting standards, Article 2, available at http://ec.europa.eu/finance/docs/level-2-measures/csrd-delegated-act-2023-5303_en.pdf.

[19] *See*, Better Finance (The European Federation of Investors and Financial Services Users), Diluted European Sustainability Reporting Standards Raise Greenwashing Concerns (August 7, 2023), available

here; World Wildlife Fund for Nature (WWF), EU Commission undermines standards for sustainability reporting (July 31, 2023), available here; Reuters, EU confirms watering down of corporate sustainability disclosures (August 1, 2023), available here.

[20] EFRAG Sustainability Reporting Standards, EFRAG Sector Specific ESRS, available at https://www.efrag.org/lab5.

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