

ESG Disclosures for Companies Operating in the EU:

The Corporate Sustainability Reporting Directive

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Sustainability reporting, i.e. company's disclosure of environmental, social and governance factors, has become a major area of change for corporates across the globe. Calls for transparency on ESG reports, as well as reliability and comparability of companies' ESG reports, are translated into concrete regulatory actions. Initially, these calls came from NGOs and activists, but they now also come from investors and regulators at an increasing pace. One of the main drivers is the need for good-quality ESG data to feed into green financing products, to combat (un)intentional greenwashing and to ensure that the sustainable finance push really does lead to a decarbonisation of the economy.

The EU aims to be a global frontrunner on all aspects of the sustainability transition. As part of this, it has kicked off a wholesale overhaul of non-financial reporting rules, including who needs to report which information and how. The changes are likely to at least quadruple the

Julia Staunig

Senior Managing Director
Teneo Brussels
+32 470 11 69 30
Julia.Staunig@teneo.com

Tomasz Krawczyk

Director
Teneo Brussels
+32 491 71 76 52
Tomasz.Krawczyk@teneo.com

Ramona Visenescu

Consultant
Teneo Brussels
+32 492 51 15 60
Ramona.Visenescu@teneo.com

scope of reporting obligations to encompass approximately 45,000 companies (the current rules apply to about 11,000). Comprehensive regulatory standards on the data and metrics to disclose are in the making, including reporting formats and auditing requirements.

All companies operating across the EU, including subsidiaries of non-EU headquartered groups, should establish whether the revised law might become applicable to them. Even if not directly in scope, companies might be impacted by the reporting obligations indirectly, as banks and capital market participants will be obliged to use the new reporting standards and will require their customers to provide the data necessary for them to do so. Indeed, a growing number of companies active in Europe have already received questions from investors, banks, customers or other stakeholders in this regard.

The Corporate Social Responsibility Directive in a nutshell

In spring 2021, the European Commission put forward a legislative proposal to change the current EU framework on how companies report on non-financial information, dubbed the “Corporate Sustainability Reporting Directive” (CSRD), which is an amendment and renaming of the current “Non-Financial Reporting Directive.” The renaming from “non-financial” to “sustainability” is more than a mere change of words; it is a recognition that sustainability is integral to the performance of a company.

The main changes under discussion are:

- **Extension of the scope of companies to be covered to include all large companies and all listed companies**, i.e. including listed SMEs but excluding small companies that might be listed.¹

- **Strengthening the quality of sustainability information by introducing mandatory EU sustainability reporting standards**, which are currently under development. These will be based on the principle of “double materiality,” i.e. businesses will have to disclose not only the key risks they face from a changing climate, for instance, but also the climate impact they themselves may cause as a business.
- **Mandatory assurance (auditing) of sustainability information**, either by a statutory auditor or audit firm or an independent, certified sustainability assurance provider.
- **Ensuring that the sustainability information is published as part of the company’s management report and is disclosed in a digital, machine-readable format**. Companies will need to prepare their financial statements and their management report in a single electronic reporting format (the EU is currently working on a standard for an “electronic single access point,” a public database) and “mark-up” (i.e. tag) the sustainability information contained within them. This would also apply to parent companies when preparing their consolidated financial statements.

The CSRD is one of the cornerstones of the EU’s plan to ensure that sustainability considerations are incorporated into corporate governance laws across the bloc. Other key elements that are closely linked are:

- The *EU Taxonomy* defining what counts as an environmentally sustainable economic activity;

¹ Such “micro-companies” are defined as companies which, on their balance sheet dates, do not exceed the limits of at least two of the following three criteria per country: (a) balance sheet total of EUR 350 000; (b) net turnover of EUR 700 000; (c) an average number of employees during the financial year of 10.

- The **Sustainable Finance Disclosure Regulation** with specific disclosures on ESG data for financial firms, which are also based on the EU Taxonomy;
- A forthcoming legislative proposal on **Sustainable Corporate Governance**, which, among other things, is set to introduce mandatory environmental and human rights due diligence in supply chains and clarify Directors' duties on sustainability.
- Subsidiaries of non-EU companies that meet the criteria for "large companies," regardless of whether or not these subsidiaries are included in the parent's consolidated report or not;
- Large companies established outside the EU that operate in the EU internal market, regardless of whether or not they have an actual subsidiary incorporated in the EU or not;
- Non-listed medium-sized companies which operate in "high-risk economic activities," i.e. industries that might have serious negative impacts on sustainability matters such as deforestation or conflict minerals.

The scope of the CSRD in detail

As highlighted above, the CSRD proposal broadens the scope of non-financial reporting obligations to include all large companies and all listed companies (except for listed micro-companies, as defined above¹). Moreover, the proposal would subject EU subsidiaries of non-EU companies and any non-EU company that lists bonds or other financial assets on an EU stock exchange to the reporting requirements. **In this regard, companies headquartered or listed outside of the EU might also be impacted by the new rules.**

Large companies are defined as those which exceed at least two of the following three criteria on their balance sheet dates:

- (a) Balance sheet total: EUR 20 million;
- (b) Net turnover: EUR 40 million;
- (c) Average number of employees during the financial year: above 250.

Some EU countries might choose to further broaden the scope. This is seen in some Member States (e.g. in Denmark and Sweden) where non-listed large companies are already required to report non-financial information.

Moreover, some Members of the European Parliament have flagged that they would like to extend the requirements to:

Future reporting standards under the CSRD

The CSRD will require companies to report according to mandatory EU sustainability reporting standards, which are currently being developed by the European Financial Reporting Advisory Group (EFRAG).

A recent progress report of EFRAG's task force in charge of preparing the standards offers a sneak peek at what they might look like.

Overall, the reporting standards will seek to take into account:

- The degree to which a company's activities are aligned with the "EU Taxonomy," i.e. the EU's definition of which business activities are deemed to be sustainable, including the criteria and thresholds that the activities will have to meet;
- The company's forward-looking business plans;
- The needs of both capital market-based and bank-based finance.

The EU sustainability reporting standards will be developed in cooperation with **key ongoing international initiatives**, such as the Global

Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the International Integrated Reporting Council (IIRC), the Climate Disclosure Standards Board (CDSB) and CDP.

Moreover, since the publication of the CSRD proposal, the International Financial Reporting Standards (IFRS) Foundation announced the creation of the International Sustainability Standards Board (ISSB) to develop a global baseline of sustainability disclosure standards. The EU process will surely also seek to align with this process, although the governance and mechanics of how this will be done in practice are yet to be defined.

Timing

The legislative process on the CSRD is ongoing. While the direction and main thrust of the proposed legislation are unlikely to change, the details of the text are still being amended. It is expected that EU institutions will finalise the law during 2022. In its current draft form, the law would require companies to start reporting according to the new rules for the reporting period of 2023. This period **might be delayed by one year**, as both the European Parliament and EU Council (i.e. the body representing EU Member States) seem to be in favour of giving companies more time to prepare for the change.

Finally, it is important to note that the CSRD – like all EU directives – will need to be implemented into Member States' national laws before it enters into force. **National legislators will be able to go beyond the minimum standards set out in the legal framework.** For example, some countries might decide to extend the scope of the rules to an even larger group of corporates.

FAQ: Three key aspects explained in detail

Are non-EU companies in scope of CSRD?

In the current proposal, all large companies and all listed companies, including SMEs, which are headquartered in the EU are in the scope of the directive.

The draft text specifies that EU-based subsidiaries of companies not headquartered in the EU are exempt from having to report under the CSRD if their parent company already reports at consolidated level in accordance with equivalent sustainability reporting standards.

However, this exemption might not hold. Certain Members of the European Parliament would like to require each EU-country subsidiary that falls within the definition of a large company to prepare its own report, regardless of whether their parent already reports at consolidated level or not. The final position of the European Parliament is likely to be known in spring 2022.

At the Council level, on the other hand, Member States currently support the position of the EU Commission regarding the exemption if there is an equivalent report at consolidated group level.

The final outcome on the level to which non-EU headquartered corporates are impacted is therefore still uncertain until the legislative negotiations are concluded sometime towards the end of 2022.

Are SMEs covered?

Listed SMEs would be covered (except for micro-companies), according to the Commission proposal. Non-listed SMEs could choose to report on a voluntary basis. It seems likely that the requirement for listed SMEs to report will also be in the final law as both the European Parliament and the Council seem to be leaning towards keeping or even extending the inclusion of SMEs.

Certain Members of European Parliament, including the lead MEP on this file, French liberal Pascal Durand from French President Macron's "En Marche" party, want to go even further. They propose to also include non-listed SMEs which operate in high-risk economic areas, defined as those that might have serious negative impacts on sustainability matters such as deforestation or conflict minerals. According to the MEP's suggestion, the Commission should adopt a delegated act to define "high-risk sectors" in detail.

In the Council, Member States seem to agree with the Commission to include only listed SMEs.

How will the CSRD align with other Commission initiatives, such as the Taxonomy and Sustainable Finance Disclosure Regulation (SFDR)?

The CSRD, together with the EU Taxonomy and the SFDR, form the backbone of the EU sustainable finance framework.

The EU Taxonomy establishes the criteria for green economic activities that make a substantial contribution to at least one EU-defined environmental goal and do no significant harm to the other goals (climate change mitigation, climate change adaptation, water conservation, pollution prevention, cyclicity and biodiversity). Companies falling under the scope of the CSRD will need to report on the extent to which their activities are compliant with the EU Taxonomy.

The SFDR requires sustainability disclosures for financial institutions. As such, it is expected that due to the extensive reporting requirements and lack of available data, financial institutions will demand more information from companies they invest in or lend to.

The CSRD proposal, therefore, ensures that companies report the information that investors and other financial market participants subject to the SFDR need. Specifically, that means that the reporting standards under development are likely to include indicators that correspond to the indicators contained in the SFDR.



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