Newsletter MAY 2021

THE EUROPEAN COMMISSION PROPOSAL ON CORPORATE SUSTAINABILITY REPORTING DIRECTIVE

1. Introduction

In the wake of the EU Green Deal and the ambitious Sustainable Finance strategy, the European Commission adopted on April 21, 2021, its proposal for a Corporate Sustainability Reporting Directive ("**CSRD**"), which will revise and extend the reporting requirements introduced by the Non-Financial Reporting Directive ("**NFRD**").

The abovementioned CSRD proposal aims to bridge the gap between sustainability information disclosed by undertakings in the scope of the NFRD and the users' needs for comparable, relevant and reliable information, as highlighted by the European Commission public consultation on the previous NFRD.

The CSRD would ensure alignment with other EU initiatives on sustainable finance, in particular the Sustainable Finance Disclosure Regulation ("**SFDR**") and the Taxonomy Regulation. It would ensure that companies report the information, which is necessary for investors and other financial market participants subject to the SFDR and the Taxonomy Regulation to comply with their recent transparency obligations.

On April 21, 2021 the Commissioners also reached a political agreement on the text of delegated acts regarding the Taxonomy Regulation, which define the technical screening criteria for the activities to qualify as "green" for the two first environmental objectives: climate change mitigation and climate change adaptation.

2. Scope of entities subject to sustainability reporting obligations

All large companies, and all companies listed on EU regulated markets (with the exception of micro-enterprises) would be required to apply EU sustainability reporting standards.

A company is 'large' if it has:

- more than 250 employees on average during the financial year, and
- a balance sheet total in excess of 20 million euros, or
- a net turnover in excess of 40 million euros.

The expanded scope would mean that approximately **49,000 companies** would have to disclose the required sustainability information, whilst approximately **11,000 entities** currently fall under the scope of the NFRD.

2.1. Groups of companies

The CSRD proposal **would exempt subsidiaries from publishing the sustainability reporting** in their management report if the sustainability reporting in the parent company's management report:

- is compliant with EU standards (or, for subsidiaries with a non-EU parent, standards deemed equivalent by the European Commission);
- includes sustainability information about the subsidiary; and
- is available when the subsidiary publishes its management report.

2.2. Disproportionate burdens for SMEs?

In order to reconcile the requirements of market transparency – involving the transition to a sustainable economy - and the need to protect SMEs from the imposition of disproportionate reporting burdens, the European Commission proposal also refers to a "***development of separate, proportionate standards for SMEs***[1]".

In particular:

- SMEs listed on regulated markets could use simpler reporting standards, calibrated to the capacity of SMEs to fulfill their legal reporting requirements, while non-listed SMEs could voluntarily decide to use them; and
- the reporting requirements for SMEs would apply starting from January 1, 2026, so that they may better manage the transition phase, also considering the extra-challenges faced as a result of the Covid-19 pandemic.

3. Scope of entities subject to sustainability reporting obligations

According to the CSRD proposal, companies shall disclose information to the necessary extent for understanding both **how sustainability impacts the company's business** (the "inside-out" perspective) and **the impact of the company's business on society and the environment** (the "outside-in" perspective). This is referred to as the "**double-materiality**". Thereby, the risks and opportunities involving the company and the effects of the company's business each represent a relevant perspective of materiality to be analyzed and disclosed.

4. Required information to report on sustainability matters

Similarly to the NFRD, the kind of "sustainability information" to be disclosed will concern at least the following matters: (i) environmental matters; (ii) social and employee matters; (iii) respect for human rights; and (iv) anti-corruption and bribery.

In terms of content, the proposed revision of the NFRD and the connected amendments to the Accounting Directive provide for both a greater level of detail for existing information requirements and a wider scope of reporting duties. In particular, Companies are to report on:

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[1] European Commission – "Questions and Answers: Corporate Sustainability Reporting Directive proposal" – April 21, 2021

- their business model and strategy, including:
    - the resilience of the company's business model and **strategy to sustainability risks related** matters;
    - the opportunities for the company in relation to sustainability matters;
    - the company's plans to **ensure compatibility of its business model and strategy with the transition to a sustainable economy** and with the limiting of global warming to 1.5 °C in line with the Paris Agreement;
    - the consideration of **stakeholder interests;** and
    - the implementation of the strategy with regard to sustainability matters;
- the sustainability **targets** set by the company and the progress made towards achieving them;
- the **role of the administrative, management, and supervisory bodies** in relation to sustainability matters;
- the company's policies relating to sustainability matters;
- the **due diligence process** implemented in relation to sustainability matters;
- the company's principal actual or potential adverse impacts connected to the **company's value chain**
- any actions taken, and the result of such actions, to prevent, mitigate or remediate actual or potential adverse impacts;
- the main **risks** related to sustainability aspects;
- **key performance indicators** relevant to the above disclosures; and
- the manner in which the company determined the information on which it reports.

The information provided shall:

- be both qualitative and quantitative;
- be both forward-looking and retrospective information;
- take account of short, medium and long-term horizons.

Where appropriate, the report content described above should also include information about the company's value chain, including the company's own operations, products and services, its business relationships and its supply chain. References to, and additional explanations of, other information received in the management report and amounts reported in the annual financial statements shall also be included where necessary.

The NFRD does not contain explicit requirements regarding the reporting of **intangible assets**, while the Accounting Directive only requires the disclosure of information on intangible assets recognised in the balance sheet. The aforementioned setting was changed in the CSRD proposal, according to the idea that information on this class of assets is underreported, provided it might account for the "*increasing gap between the accounting book value of many undertakings and their market valuation, which is observed in many sectors of the economy*". Information on intangibles should therefore include, for example, intellectual capital, human capital (including skills development), social and relationship capital (including reputational capital) and research and development.

5. EU sustainability reporting standards

In order to specify the information that companies shall report and the structure in which that information shall be reported, the CSRD proposal provides for the mandatory application of sustainability reporting standards. The standards will be developed by the European Financial Reporting Advisory Group ("**EFRAG**") and consequently adopted by the European Commission by the following dates:

- by **October 31, 2022**, a **first set of sustainability reporting standards** shall be published, specifying the basic information needed by financial market participants to carry out their disclosure duty;
- by **October 31, 2023**, a **second set of sustainability reporting standards** shall follow, primarily including complementary information and sector-specific disclosures. The rationale for developing sector-specific disclosures is that companies in the same sector are often exposed to similar sustainability-related risks and often have similar impacts on society and the environment. Consequently, comparisons between companies in the same sector are particularly valuable to investors and other users of sustainability information;
- in addition, the European Commission plans to publish **separate sustainability reporting standards** for SMEs (as illustrated above) by **October 31, 2023**, that take into account SMEs' capacities and characteristics. These will be also addressed to SMEs that are not in the scope of sustainability reporting within the Accounting Directive.

The first two sets of standards shall be reviewed by the European Commission every three years.

The European Commission has made it clear that European standards shall align to international ones. The European Commission has also expressed its support for the initiatives of the G20, the G7, the Financial Stability Board and others (among which the International Financial Reporting Standards (IFRS) Foundation, the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the International Integrated Reporting Council (IIRC) and the Climate Disclosure Standards Board (CDSB) to develop a baseline of global sustainability reporting standards that would build on the work of the Task Force on Climate-related Financial Disclosures.

6. Publication of non-financial statement

Under the CSRD, sustainability information will have to be included in the **companies' management report**. The CSRD proposal therefore eliminates the current possibility for Member States to allow companies to publish the required information in a separate report.

This provision aims to promote integration and accessibility of information and to ensure the same level of responsibility for management and board of directors for the preparation of the sustainability report as for the preparation of the financial report.

Moreover, the CSRD would require companies to prepare their financial statements and their management report in XHTML format ESEF Regulation and to "tag" their reported sustainability information according to a digital categorisation system as and when specified in that Regulation. This in order to facilitate the incorporation of the sustainability information in the "**European Single Access Point**" envisaged in the Capital Markets Union Action Plan, for which the Commission will put forward a proposal later this year.

7. Audit and penalties

The CSRD proposal also introduces a general EU-wide audit (assurance) requirement for reported sustainability information, which will help to ensure that reported information is accurate and reliable.

Although the objective is to have a similar level of assurance for financial and sustainability reporting, the European Commission has provided for a progressive approach.

Initially, under the CSRD, auditors[2] shall in fact express an opinion based on a "**limited assurance**" engagement as regards the compliance of the sustainability reporting with the requirements of the CSRD, including the applicable reporting standards.

It is anticipated that the "limited" assurance could change to a "**reasonable assurance**" at a later stage, once the sustainability standards are published and following a review by the European Commission within 3 years after the CSRD comes into force.

The CSRD will require the Member States to provide for minimum sanctions for non-compliance with sustainability reporting requirements, these being: (i) a public statement indicating the natural person or the legal entity responsible and the nature of the infringement; (ii) an order requiring the natural person or the legal entity responsible to cease the conduct constituting the infringement and to desist from any repetition of that conduct; and (iii) administrative pecuniary sanctions.

8. Timing and next steps

The next step is for the European Parliament and the Council to negotiate a final legislative text on the basis of the European Commission's proposal.

According to the European Commission proposal, the transposition of the CSRD into national law will take place within **December 1, 2022**, so that the amendments would be applicable for the first time for fiscal years beginning on or after **January 1, 2023**. The requirements for listed SMEs will apply to fiscal year beginning on **January 1, 2026**.

[2] The European Commission's proposal allows Member States to open up the market for sustainability assurance services to so-called "independent assurance services providers", provided they are subject to requirements consistent with those applicable to auditors; therefore Member States could chose to allow firms other than the usual auditors of financial information to assure sustainability information.

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