Debevoise & Plimpton

Debevoise In Depth

The European Sustainability Reporting Standards, the Centerpiece of CSRD

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Introduction

Businesses worldwide with operations in the European Union (the "EU") are now preparing for compliance with the EU's Corporate Sustainability Reporting Directive (the "CSRD"), a new framework that will require companies with securities listed on an EU "regulated market" or large EU companies in scope to include sustainability information in their annual reporting. CSRD will be accompanied by the European Sustainability Reporting Standards (the "ESRS"), which detail the reporting required and which the EU Commission (the "Commission") has called the "centrepiece" of this legislation. Following implementation into the national law of EU Member States, the CSRD's requirements will be phased in for reporting periods beginning on or after 1 January 2024. We describe the companies in scope and the timing of application of CSRD's requirements in our recent Debevoise In Depth.

Companies in scope of CSRD must include information on sustainability matters in their annual management reports. In addition, EU parent companies of a large group must include information necessary to understand the group's impacts on sustainability matters in the consolidated management reports. Companies in scope must also disclose information on the alignment, if any, of their activities with the EU Taxonomy Regulation ("Taxonomy Regulation"), which specifies different types of environmentally sustainable activities and defines criteria for assessing alignment (under the "contribution" and "do no significant harm" tests).

Although sustainability reports under the ESRS will not be published for some years, companies in scope of CSRD are well advised to review the ESRS at this stage, as the draft ESRS contain the expected scope and breadth of sustainability reporting required under CSRD. Sustainability reporting will likely also have an impact on related business operations and procedures. ESRS 1 (General requirements) outlines the degree to which data should be reported on an entity-by-entity basis within a consolidated group and sets out key principles such as the test of "materiality" for reportable information. The specific reporting standards act as questionnaires, in each relevant environmental and social field, for an extensive set of information to be reported, including a company's due diligence processes, approaches to addressing particular areas of harm and numerous metrics.

The ESRS take into account a number of existing voluntary sustainability reporting frameworks, and it is the EU's clear intention that companies that report according to the ESRS will no longer report according to any voluntary standard. This is discussed further below. The EU also expects that the ESRS will replace the many existing channels that companies currently make use of to supply environmental and social information, such as through completion of ad hoc questionnaires.

Publication of First Draft ESRS and Timeline

EFRAG (formerly the European Financial Reporting Advisory Group), which is assigned by CSRD to provide technical advice to the Commission in the form of fully prepared draft ESRS, submitted the first set of draft ESRS to the Commission on 23 November 2022. The Commission will consult with other EU bodies (including the European Environment Agency and the European Central Bank) and Member States on the draft ESRS, and is expected to adopt the first set of standards by delegated acts in June 2023, followed by a scrutiny period by the European Parliament and Council.

The first draft package of ESRS comprises:

- Two sets of "cross-cutting" standards:
  - ESRS 1 covers general requirements and explains the key concepts of double materiality, reporting on the value chain and how to prepare and present sustainability information.
  - ESRS 2 covers general disclosures, including on governance, strategy, impact, risk and opportunity management, and metrics and targets.
- Three sets of "topical" standards for environmental, social and governance disclosures:
  - Environmental disclosures ESRS E1 to E5 cover climate change, pollution, water and marine resources, biodiversity and ecosystems, and resources and the circular economy.

- Social disclosures ESRS S1 to S4 cover an organisation's own workforce, workers in the value chain, affected communities and customers and end-users.

- Governance disclosure ESRS G1 covers business conduct.

The second package draft ESRS will cover sector-specific standards. These will include sectors covered by the Global Reporting Initiative, namely: agriculture, coal mining, mining, oil and gas (upstream), oil and gas (mid-to downstream) and other sectors regarded as high-impact, namely: energy production, road transport, motor vehicle production, food and beverages, and textiles.

Specific Standards for SMEs and Non-EU Companies

The EFRAG is also developing specific standards for small- and medium-sized undertakings ("SMEs"), which are intended to be "proportionate and relevant to the capacities and characteristics" of SMEs, and for non-EU companies that are indirectly brought in scope of the CSRD in 2028 (by way of their EU subsidiaries or branches).

Voluntary Standards for Companies Outside Scope of CSRD

EFRAG has also published a proposal for voluntary sustainability reporting standards for SMEs that are outside the scope of CSRD. These standards are a considerably simplified version of the full ESRS and are therefore consistent with the CSRD at a high level. Companies outside the scope of CSRD may adopt these standards as a means of responding to questionnaires from companies in scope of CSRD, although it is not yet clear whether the voluntary standards will be sufficiently comprehensive for that purpose.

Key ESRS Concepts

Companies will need to clearly select relevant information to report under each ESRS based on considerations of relevance and materiality and should consider the requirement to report on **impacts in the company's own operations and, where specified, in its "value chain", broadly meaning the resources and activities used by a company to conceive and deliver its products or services**. Particular challenges arise for large groups with different types of operations in different jurisdictions. The ESRS provide guidance on these points.

Double Materiality Principle

The ESRS require companies to report, under the relevant environmental, social or governance standard, all material information regarding positive and negative impacts, risks and opportunities. The ESRS provide guidance on materiality, specifying both **"financial materiality" (how sustainability issues create financial risks for the company)** and **"impact materiality" (the company's own impacts on people and the environment)**, and companies will need to develop their own criteria in this regard in line with the principle of "double materiality". Under the "double materiality" principle, companies must consider the impacts of their activities on people and the environment from the perspective of society as a whole and how sustainability matters affect the company from a financial risk perspective. ESRS S1 (and in particular, Appendix B) provides guidance on assessing materiality, taking into account considerations such as the degree to which the impact is directly linked to the company's operations (including through its value chains) and financial materiality.

If a company decides that a particular topic covered by the ESRS is not material, it may omit reporting on that topic with a suitable justification.

PAI Indicators Always Reported

Importantly, the ESRS specify a number of points that must always be reported, including all the "principal adverse impact" indicators in the EU Sustainable Finance Disclosure Regulation ("SFDR"), the climate related disclosures (ESRS E1) and, for companies with 250 or more employees, the bulk of the disclosures in ESRS S1 (Own workforce).

Time Horizons

The sustainability report will cover the same reporting period as the financial statements, with all metrics disclosed with one year of comparative information (and with narrative information compared to prior periods when considered helpful). When reporting sustainability information, companies need to consider and specify whether particular impacts are important on a short- (the financial year), medium- (to five years) and long-term (more than five years) horizon.

Consolidation

A company will generally prepare and publish its sustainability report according to the same consolidation as its financial report, although EU companies with non-EU parent companies will need to consider whether to produce a sustainability report only for those EU companies in scope or on a voluntary basis for the world-wide group.

When associates or joint ventures are part of the company's value chain, a company should include information related to those associates or joint ventures, taking into account information at the level of the associates or joint ventures on impacts that are directly linked to the company's products and services through its business relationships. In a number of instances, particularly in relation to greenhouse gas ("GHG") emissions, the reporting standards specifically require information on data at the level of associates or jointly controlled entities.

Value Chain Reporting

The ESRS make it clear that reporting scope is extended to include a company's upstream and downstream value chain. **"Value chain" is broadly defined to encompass "upstream" entities (suppliers) and "downstream" entities (distributors and customers) that the company depends upon for its business model. In the ESRS, material impacts, risks or opportunities in the value chain must be disclosed only when specifically requested in the topical standards.** Examples of such requests in the topical standards are the extensive information to be collected in the ESRS S2 ("Workers in the value chain"), scope 3 carbon emissions and transition plans to meet the EU Biodiversity Strategy by 2030, which includes the plans for the company's own operations and throughout its value chain.

Under CSRD, for a transitional period, if not all the necessary information regarding its value chain is available, a company can explain the efforts made to obtain the necessary information, the reasons why it could not obtain all the necessary information and its plans to obtain the necessary information in the future. This relief will not apply to data-points covered by the ESRS that are required by other EU regulations. In addition, EFRAG proposes that a number of disclosure requirements will be phased in over time.[1]

"Trickle Down Effect" for Companies Not in Scope

EFRAG has pointed to a "trickle down effect" for companies that are not in scope of CSRD but are required to report information to companies in scope. With this in mind, the Commission intends that the separate sustainability reporting standards for SMEs will be a reference point for companies within scope of the full ESRS as to the level of sustainability information that such companies could reasonably request from SMEs in their value chain. CSRD also specifies that the ESRS may not require reporting of information that would require companies to obtain information from SMEs in their value chain that exceeds the information to be disclosed according to the separate sustainability reporting standards for SMEs.

Under the ESRS, where a company cannot collect value chain information, it must estimate relevant information using all reasonable and supportable information, such as sector-average data and other proxies.

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[1] Appendix D of ESRS 1.

Disaggregation of Information by Entity, Country, Site or Asset

As above, information is generally reported for the entire consolidated group. As an important qualification to this rule, a company is required to provide additional entity-specific disclosures where it concludes that a particular material impact, risk or opportunity is not covered, or is covered with insufficient "granularity", by an ESRS. Similarly, when needed for a proper understanding of its material impacts, risks and opportunities, a company should disaggregate the reported information: (i) by country, when there are significant variations across countries and when presenting the information at a higher level of aggregation would obscure material information about impacts, risk or opportunities; or (ii) by significant site or asset, when material impacts, risks and opportunities are linked to a specific location or asset. Businesses with extensive geographical footprints will have to make significant judgments as to the level of information given in relation to, for instance, their workforce and their business and environmental policies.

Governance

The ESRS also require a company to disclose governance-related information, including the composition of its administrative, management and supervisory bodies and their roles, responsibilities and expertise; sustainability reporting lines; integration of sustainability-related performance in incentive schemes; risk management and internal control systems; the company's market position, business model and value chain; and how the interests and views of its stakeholders are taken into account.

Links with Financial Statements

Under the ESRS, when sustainability statements include financial data and assumptions, these should be consistent, to the extent possible, with the corresponding data and assumptions used in the financial statements and can also be incorporated by reference to the financial statements. Companies may also incorporate information in the sustainability report by reference to the financial statements.

Climate Related Information: Transition to Limiting of Global Warming in Line with Paris Agreement

ESRS E1 covers climate change adaptation and mitigation and energy. **In line with the CSRD, the standard requires a company to provide a description of its plans to ensure its business model and strategy are compatible with a transition to a sustainable economy and the limiting of global warming to 1.5 degrees in line with the Paris Agreement and the EU's objective of being climate neutral by 2050.** A recital to CSRD clarifies that this does not create a substantive obligation to produce a transition plan but to disclose "any plans [the company] may have" to align its business model and strategy with the climate goals. If the company does not have a transition plan in place, it should indicate whether and, if so, when it will adopt a transition plan.

Relation with Other EU ESG Legislation

EFRAG includes an explanatory note to demonstrate that the ESRS take account of EU initiatives and legislation, including the SFDR, the European Climate Law and the EU Taxonomy, as well as the EU's goal for climate neutrality. From a shareholder perspective, the ESRS are, together with the CSRD, designed to include all the information points that investors require under the existing EU ESG framework (the SFDR and the Taxonomy). In particular, all the "principal adverse impacts" ("PAI") indicators of the SFDR are included within the ESRS, and EFRAG supplies a helpful note to show the location of each PAI indicator in the relevant ESRS.

We also expect there to be a large overlap between the due diligence obligations in the proposed Corporate Sustainability Due Diligence Directive (the "CSDDD") and the CSRD reporting obligations. For instance, there is a strong correlation between the requirements of ESRS S2 (Workers in the value chain) and the CSDDD, in that each requires the company to identify material environmental and social impacts within its value chain, although ESRS S2 is potentially broader than CSDDD, as its scope covers a wide range of sustainability related impacts, risks and opportunities, whilst CSDDD is focused on adverse human rights and environmental impacts.

It is also interesting to note that the CSDDD, which will apply to many of the same companies in scope of CSRD, requires companies to draw up and publish a climate transition plan.

Relation with Other International Reporting Standards

CSRD recognises the need for coherence of sustainability reporting standards at the global level. To that end, CSRD stipulates the existing standards that the ESRS are required to take account of, and EFRAG supplies an explanatory note demonstrating that the ESRS align with the Task Force on Climate-Related Financial Disclosures ("TCFD"), the GHG Protocol, the Global Reporting Initiative Standards, the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises. There is also a Reconciliation Table that shows the correlation between ESRS E1 (Climate) and TCFD and the additional climate-related information required under ESRS E1.

Possible Equivalence with ISSB

A key question, and one that may remain outstanding for some time, is whether the EU will determine that the reporting standards currently being produced by the International Sustainability Standards Board (the "ISSB") of the IFRS are "equivalent" to the ESRS. This will allow EU subsidiaries of non-EU parent companies in scope of CSRD to benefit from an exemption from the obligation to produce a sustainability report where the EU subsidiary (and its subsidiaries) are included in the consolidated sustainability reporting of the parent, provided that the parent's consolidated sustainability reporting is carried out in a manner that is determined as "equivalent" to those sustainability reporting standards. Equivalence decisions are future work for the EU.

EFRAG, when submitting the draft ESRS to the Commission, noted in its cover letter the need to consider alignment between ESRS and the proposed ISSB standards, and stated that it has "sought as much interoperability as possible in both structure and contents within the parameters set by the CSRD". EFRAG also noted that "from a general standpoint the goal is that the companies which comply with ESRS are also considered as complying with the ISSB standards to avoid unnecessary multiple reporting".

EFRAG has produced a comparison table between IFRS S1 Exposure Draft (General requirements) and ESRS 1 and 2 (General requirements and disclosures) that indicates a close correlation between the two reporting standards, although one important point of difference is that all IFRS data points are based on a materiality assessment, whilst ESRS have a list of mandatory data points, irrespective of the materiality assessment. EFRAG has also produced a comparison table between IFRS S2 (Climate-related disclosures) and ESRS E1 (Climate) that indicates a close correlation, although ESRS E1 requires additional disclosure (such as reference to alignment with limiting global warming to 1.5 degrees), and ESRS E1 does not allow the use of carbon credits or offsets to achieve GHG-emission targets.

It is clear that compliance with the ESRS will likely result in compliance with the ISSB standards. Whether the EU will determine that the ISSB standards are equivalent to the ESRS will likely be a major point of focus, and lobby, for world-wide companies in scope of CSRD.

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Please do not hesitate to contact us with any questions.

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