European Sustainability Reporting Standards

5 July 2023

INTRODUCTION

Businesses worldwide with operations in the European Union ("EU") are preparing to comply with the EU's Corporate Sustainability Reporting Directive (the "CSRD"). This new framework requires EU companies with securities listed on an EU "regulated market" or large EU companies in scope to include sustainability information in their annual reporting. The CSRD's requirements will be phased in for financial years beginning on or after 1 January 2024.

As required by the CSRD, the European Commission (the "Commission") recently published a draft Delegated Regulation with European Sustainability Reporting Standards ("ESRS"), which detail the reporting required. The Commission made some significant changes to the form of ESRS originally proposed by the EFRAG (formerly the European Financial Reporting Advisory Group) in November 2022 (see our Debevoise In Depth of February 2023).

Companies that will be in scope of CSRD should review the ESRS to understand the scale of reporting required. The ESRS comprise over 600 data points, although phase-in requirements and considerations of materiality will in practice reduce the amount of information companies must report. Qualitative and quantitative data includes due diligence processes for environmental and social risks, approaches for addressing particular areas of potential harm and numerous metrics.

COMMISSION'S DELEGATED REGULATION

The Accounting Directive, as amended by CSRD,[1] requires the Commission to adopt the first of the four sets of ESRS by 30 June 2023. As the Commission published the draft on

1 Directive 2013/34/EU f the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings.

9 June 2023, with a feedback period until 9 July, and as the Delegated Regulation requires approval by the European Parliament and Council, there will be some time before the Commission adopts the finalised ESRS. Companies are best advised for the time being to plan their CSRD implementation on the basis of the Commission's draft.

The first set 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 roles and responsibilities of management bodies on sustainability matters, risk management and due diligence on sustainability matters, interests and views of stakeholders and the company's overall strategy and business model.
- 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, resource use and circular economy.
  - Social disclosures: ESRS S1 to S4 cover an organisation's own workforce (both employees and non-employees), workers in the value chain, affected communities and consumers and end-users.
  - Governance disclosures: ESRS G1 covers business conduct, such as bribery and corruption, payment practices and political lobbying activities.

EFRAG is currently working on the second, third and fourth sets of ESRS. These will, respectively, set out "sector specific" standards, (disclosure requirements for companies in particular industries, including financial services), proportionate standards for small and medium-sized companies with securities listed on an EU regulated market, and standards for non-EU companies which will fall within scope of CSRD from 2028, by virtue of their significant EU operations.

KEY CHANGES INTRODUCED BY THE COMMISSION

It is clear that the Commission is concerned about the scale of the reporting required, particularly by smaller EU companies. In light of that, in its draft Delegated Regulation, the Commission has proposed a number of changes to the scope of the ESRS :

- Except for the standards, disclosure requirements and data points under ESRS 2, all standards, disclosure requirements and data points within each standard will be subject to the materiality assessment. This means that a company can omit a particular topic or sub-topic within these standards, if it does not consider it to be material, from a financial and broader impact perspective. This is primarily based on considerations of the cost and time involved, particularly for smaller companies, in publishing information which they may not consider material. Compared to the EFRAG draft, this relieves companies from reporting under ESRS 1 (Climate change) and ESRS S1 (Own workforce) where the company does not consider the topic or sub-topic relevant to its operations. As a consequence, if they do not consider the information material, companies are no longer required to report on disclosure and data points that correspond to the principal adverse impact indicators in the Sustainable Finance Disclosure Regulation ("SFDR"), information that EU financial institutions need to meet "Pillar 3" capital requirements, and information needed by benchmark administrators under the Benchmarks Regulation. This is the most controversial change proposed by the Commission, and has attracted some criticism, raising questions about how financial market participants, which are in some cases required to report principal adverse impacts under SFDR, will in the future obtain and publish data where their investee companies do not consider the relevant data material.

- Certain requirements, determined by the Commission as the most challenging data points to collect, are subject to additional phase-in, specifically:

  - Companies with fewer than 750 employees may omit: scope 3 greenhouse gas emissions data and the disclosure requirements specified in the ESRS on "own workforce" in the first year that they apply the standards; and the disclosure requirements specified in the ESRS on biodiversity and on value-chain workers, affected communities, and consumers and end-users in the first two years that they apply the standards.

  - All companies may omit the following information in the first year when they apply the standards: anticipated financial effects related to non-climate environmental issues (pollution, water, biodiversity, and resource use); and

certain data points related to their own workforce (social protection, persons with disabilities, work-related ill-health, and work-life balance).

By introducing this new phase-in relief, the Commission has accepted that it cannot undermine CSRD's over-arching requirement for companies to report all material sustainability matters from the outset. Hence, it has stated in the ESRS that any company omitting information under the phase-in relief must, in relation to the topics which are subject to phase-in relief, assess their materiality and disclose, if material, how the company's business model takes account of those matters, with brief descriptions of related targets, policies, actions and metrics.

- The Commission has converted a number of the mandatory data points into voluntary data points (indicated as "may disclose" as opposed to "shall disclose"). This includes, in particular, certain data points in the biodiversity standards which are regarded as particularly challenging to report on, such as biodiversity transition plans; certain (but by no means all) metrics about "non-employees" (self-employed contractors and agency workers) in the company's own workforce, given the challenges of collecting data on non-employees; and reporting on confirmed incidents of bribery and corruption, given concerns that it would expose companies to self-incrimination and resulting litigation risks.

- The Commission has also made voluntary an explanation in each case of why the undertaking considers a particular sustainability topic (or sub-topic) not to be material under the required materiality assessment. Therefore, while companies will need to explain the overall process by which they identify impacts, risks and opportunities as material, they will not need to justify the omission of reporting on a particular topic.

- There is a new rule that allows companies to omit classified and sensitive information. The ESRS gives these terms specific meanings, which relate to the protection of confidential information in the European defence, national security and international relations context.

- Companies may now signal that forward looking information, such as estimates, is subject to uncertainty, designed to address the risk of legal action against companies when they publish this information.

- The Commission has omitted the requirement to disclose any "insufficiencies" in actions taken to address causes of anti-corruption and anti-bribery, to remove the risk for companies of self-incrimination. The requirement now is only to disclose actions taken, without companies needing to consider whether the actions are insufficient.

The Commission has also introduced a separate glossary document which covers all acronynms and defined terms, and confirmed that all climate related definitions in ESRS E1 and the climate related disclosures in the IFRS International Sustainability Standards Board (S2) are now common and hence "inter-operable".

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Please do not hesitate to contact us with any questions.

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