CSRD—Impact on Private Equity

13 September 2023

The EU's Corporate Sustainability Reporting Directive ("CSRD") is a new framework that requires companies to include a large body of sustainability information in their annual reporting, in accordance with the detailed European Sustainability Reporting Standards ("ESRS"), combined with external "assurance" of the information provided. CSRD first takes effect for financial years beginning on or after 1 January 2024 for companies (EU and non-EU) with securities listed on an EU "regulated market". From 2025, large private EU companies will be in scope.

Given the preparation required, private equity firms are well advised to start to consider the impact of CSRD, and we outline in this Update suggested steps for firms to take.

Application to Unlisted Companies. In terms of its application to unlisted companies, CSRD will apply to all "large" EU companies (including EU subsidiaries of non-EU parent companies) which exceed at least two of the following criteria:

- more than 250 employees;
- net turnover of more than €40 million; or
- balance sheet total of €20 million.

The EU expects some 50,000 EU companies to be in scope, which may well be an under-estimate.

From 2028, CSRD's scope broadens for EU companies headed by non-EU parent companies to encompass the worldwide group, subject to the group as a whole generating at least €150 million of turnover in the EU. These reports will follow simplified reporting standards, which are currently under development and are expected to be adopted by the European Commission in 2024.

Application of CSRD to Sponsors That Are Themselves in Scope. As a first step, private equity sponsors should consider whether any EU entity in their own group

(generally comprising the management and advisory companies, any service companies and general partners) is in scope. If the EU entity is a parent company, the criteria are assessed by reference to the parent and its EU and non-EU subsidiaries in aggregate. Whilst sponsors may not meet the employee test, they may well exceed both the turnover and balance sheet thresholds.

For sponsors that are themselves in scope, there are a number of steps to take:

- **Identify the entities in scope**. This may comprise the whole group (if headed by an EU parent company) or particular EU entities or sub-groups within the larger group.

- **Consider the scope of reporting required**. Firms in scope will apply a "materiality" assessment to determine the most relevant information in the reporting standards to report. On a broad view of the ESRS, which are divided into general and topical standards, private equity firms should anticipate reporting on the general disclosures (which cover matters such as strategy, governance and risk management), which are always considered material, and the topical standards covering "business conduct", "own workforce" and "consumers and end-users". Each of the standards requires extensive reporting of matters such as relevant policies, actions planned to address harms and of extensive data—the own workforce standard alone amounts to almost 40 pages. Firms will likely conclude that they can omit at least some of the environmental topical standards (such as those covering pollution and impact on biodiversity from their activities), although most firms will likely report on the climate change standards. It is worth noting both that the climate change standard is closely aligned to the existing Taskforce on Climate related Financial Disclosures (TCFD) climate reporting framework, which many firms currently adhere to voluntarily, and that if firms decide that the climate change standard is not "material" in the context of their activities, they will need to provide reasons for that decision. Although the ESRS contains all "principal adverse impact" data under the Sustainable Finance Disclosure Regulation ("SFDR"), all such data is subject to the materiality filter, meaning that sponsors will not necessarily receive "principal adverse impact" data from all portfolio companies in scope of SFDR.

- **Consider the scope of value chain reporting required**. As well as reporting on own operations, CSRD requires, where specified in the ESRS, reporting on environmental and social matters in companies' value chains—broadly defined as its supply, marketing and distribution channels, with customers also treated as part of the value chain. "Value chain workers" has a narrower definition, meaning workers in the upstream and downstream value chains "who are or can be materially impacted" by the company which is reporting.

- **Application of value chain concept to asset managers**. There are some key open questions as to how this concept will apply to financial services providers and whether it will as a consequence broaden the reporting required. In the ESRS climate change reporting standard, there is a requirement for "financial institutions", when reporting on Scope 3 emissions, to consider the GHG Accounting and Reporting Standard for the Financial Industry, specifically the parts dealing with Financed Emissions and Insurance-Associated Emissions. This amounts to a requirement for asset managers (and insurers) to report on the GHG emissions in their portfolios, which is a familiar concept in existing climate change reporting frameworks. Otherwise, the application of the value chain concept to asset managers, and specifically whether it will broaden the scope of a firm's reporting to include other environmental and social impacts at the portfolio company level, is presently unclear. Many firms act as sub-advisors or delegated portfolio managers to other entities, including within their group. These other entities are "customers" and hence part of their "value chain", but there are open questions as to whether, and to what degree, they should report on the social and environmental impacts of these other entities. EFRAG, the EU body responsible for the reporting standards, published a paper in February 2023 that signals future work on sector-specific reporting standards for financial institutions and notes in the paper the "broad implications" of reporting throughout the value chains of financial institutions. The paper also notes that the forthcoming Corporate Sustainability Due Diligence Directive "will be a relevant point of reference for sector specific guidance for financial institutions and appropriate consideration in the timeline and approach should be given on how to ensure compatibility". However, given EFRAG's prioritisation of sector-specific standards for industries with high environmental and social impacts (such as mining and agriculture), it does not expect to issue draft financial services sector standards until 2024.

- **Locate an external assurance provider**. The major auditors are preparing teams for sustainability reporting; otherwise, member states may authorise other independent certified assurance providers to perform the role. Sponsors will need to consider the engagement terms and the scope of the work that the provider proposes for the "limited" assurance exercise, which will require the service provider to exercise significant judgement as to the type of checks performed.

Application of CSRD to Portfolio Companies. Separately, sponsors should identify those portfolio companies which are likely in scope of CSRD. This will either be the whole group, if headed by an EU parent, or otherwise particular EU entities (or EU "sub-groups") within the group.

Given the amount of preparation required for reporting in 2025 in respect of financial years beginning on or after 1 January 2024, there is a good case for sponsors to set up a

forum to educate and share best practice on CSRD reporting for their portfolio companies. This could take the form of assistance with initial scoping exercises, including any decision for non-EU headed groups to report on CSRD on a voluntary, worldwide basis; selection of candidates for the external assurance provider and discussion on their terms of engagement; understanding the reporting standards and the related "materiality" assessment and identification of the most important value chains; identifying the gaps in environmental, social and governance data that the company currently collects as against the data required under the reporting standards; preparing reporting and related management systems at portfolio companies, including the extended role of audit committees; and preparing questionnaires for companies in the supply and distribution chains.

Sponsors will also need to consider under CSRD the position of structures, such as holding companies for portfolio company groups, and co-investment vehicles, which may be governed by nominated directors of the fund sponsor. The EU Accounting Directive sets out the current basis for consolidated financial reporting by groups. CSRD, by means of a series of additions to the Accounting Directive, introduces sustainability reporting on largely the same basis. Hence, the expectation is that the scope of consolidated sustainability reporting will follow the scope of existing financial reporting for a given group, and funds, holding companies and co-investment vehicles will be consolidated for sustainability reporting only where they are consolidated for financial reporting. However, complications may arise. CSRD reporting initially brings into scope only the EU companies (or EU parent companies) that sit within worldwide groups, whilst financial consolidation generally comprises the worldwide group. In addition, the sustainability reporting standards do not explicitly include the same exemptions for, for instance, consolidation between funds and portfolio companies, that have been developed under financial reporting standards. The treatment of interests in "associates" (which are entities over which an investor has significant influence but not control) and joint ventures is also specifically addressed in certain of the reporting standards. Sponsors are well advised to consult with their legal counsel and assurance provider on these types of scope issues at an early stage.

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Please do not hesitate to contact us with any questions.

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