EUROPEAN COMMISSION PROPOSES NEW CORPORATE SUSTAINABILITY REPORTING LEGISLATION

Date: 28 April 2021

Policy and Regulatory Alert

By: Giovanni Campi, Karishma Shah Page, Andrew J. Massey, Daniel F. C. Crowley, Sofia Karagianni

THE NEED FOR A NEW SUSTAINABILITY REPORTING FRAMEWORK

On 21 April 2021, the European Commission (the Commission) adopted the Sustainable Finance Package (the Package).

The Package is comprised of an ambitious set of policy measures aimed at boosting sustainable investments to finance an inclusive economic recovery from the COVID-19 pandemic and help the redirection of private capital towards green activities.

The Package includes, among other things, a legislative proposal on a new Corporate Sustainability Reporting Directive (CSRD), which would revise the existing reporting rules introduced for public-interest entities by the Non-Financial Reporting Directive (NFRD).[1] The CSRD would also amend provisions from the Transparency Directive,[2] the Audit Directive[3] and the Audit Regulation.[4]

The CSRD proposal follows the European Parliament's call for an extension of the scope of NFRD beyond public-interest entities, and the Commission's identification of deficiencies with the existing non-financial reporting framework. Those deficiencies centered on the uncertainty and complexity for companies on what, how, and when to disclose non-financial information. Importantly, the Commission indicated in various instances that companies within the scope of the NFRD either report partially or do not report the non-financial information that market participants deem necessary.

THE CSRD'S TEN KEY PROVISIONS

The CSRD would strengthen the existing rules under the NFRD by making the following changes:

1. Extending the scope to include all large companies and all companies listed on regulated markets except listed micro-companies. Large companies not listed on regulated markets are defined as companies that exceed at least two of the following criteria: (i) a balance sheet total of €20,000,000; (ii) a net revenue of €40,000,000; and (iii) an average number of 250 employees during the financial year. The Commission estimates that this will result in around 50,000 companies reporting sustainability information, compared to the current 11,600 companies that are within the scope of the NFRD.
2. Companies not established in the European Union but with securities listed on EU regulated markets would also be required to disclose information on sustainability matters.

3. For listed small and medium sized enterprises (SMEs) that are not listed micro-enterprises, the reporting requirement would commence three years after the CSRD enters into application.
4. For non-listed SMEs, the Commission intends to develop voluntary proportionate standards by October 2023.
5. Clarification of the principle of double materiality. This provides that companies should report information necessary to understand how sustainability matters affect them, and information necessary to understand the impact they have on people and the environment.
6. Requiring sustainability information to be made available in a digital format, pointing to the development of the European single electronic format[5] for the publication of corporate information. The Commission envisages that the reported sustainability information, which would be digitally tagged, could be disclosed by companies in the European single access point, which is due to be established in Q3 2021.
7. The removal of the possibility for member states to allow companies to report the required information in a separate report that is not part of the management report.
8. The introduction of a general EU-wide audit (assurance) requirement for reported sustainability information. The current framework only includes a requirement for the statutory auditor to assess whether non-financial information has been provided. The new rules task the statutory auditor with performing a limited assurance engagement on a company's sustainability reporting, including on the compliance of the sustainability reporting with the reporting standards. The CSRD also allows member states to authorize independent assurance services providers other than statutory auditors or audit firms to carry out the assurance of sustainability reporting. This is intended to offer companies a broader choice of assurance service providers for the assurance of sustainably reporting.
9. Requiring sustainability reporting to address certain matters, including: (i) a company's plans to ensure its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5°C in line with the Paris agreement; (ii) a description of the role of the board and management with regard to sustainability matters; (iii) a description of the principal adverse impacts connected to the company and its value chain, any actions taken to prevent, mitigate or remediate such adverse impacts, and the results of such action; (iv) a description of the principal risks related to sustainability matters, including how the company manages those risks; and (v) a description of the targets related to sustainability matters and the profess towards achieving those targets.
10. Mandating the development of sustainability reporting standards with regard to environmental, social and governance factors. In light of the extension to non-EU entities that are listed on EU regulated markets, the CSRD also empowers the Commission to adopt measures to establish a mechanism for the determination of the equivalence of sustainability reporting standards used by non-EU issuers and to take the necessary decisions on such equivalence. The first set of these standards would be adopted by October 2022. In developing these standards, the Commission would have to take into account the technical advice of the European Financial Reporting Advisory Group (EFRAG). At the same time, the sustainability reporting standards should take account of existing standards and frameworks for sustainability reporting and accounting, including initiatives such as the task force on climate-related financial disclosures. In this regard, a first glimpse of what these standards could look like can be seen in an EFRAG report published in early March. The report describes the scope and structure of future

sustainability reporting standards, without, however, setting out specific disclosure requirements, indicators, or metrics. Finally, yet importantly, the CSRD provides that the Commission should, at least every three years after its date of application, review the standards and where necessary amend taking into consideration relevant developments, including with regard to international standards.

THE EUROPEAN PARLIAMENT TAKE

Although the European Parliament has not yet taken an official position on CSRD, in a recent non-binding report on sustainable corporate governance, it outlined its vision on non-financial reporting. Many of the European Parliament's recommendations appear to have been taken up by the Commission in the CSRD proposal. These include, among others: the need for clear and comparable disclosures, the support of a process to develop EU non-financial reporting standards, and the extension of the scope of the directive to all large listed companies in the European Union.

NEXT STEPS

The draft proposal will now be debated by the co-legislators (i.e., European Parliament and the Council of the European Union). If the co-legislators reach an agreement in the first half of 2022, then the Commission will be able to adopt the first set of reporting standards under the new legislation by the end of 2022. This means that companies would apply the standards for the first time to reports published in 2024, covering the 2023 financial year.

FOOTNOTES

[1] Directive 2014/95/EU.

[2] Directive 2004/109/EC.

[3] Directive 2006/43/EC.

[4] Regulation (EU) No 537/2014.

[5] Commission Delegated Regulation (EU) 2018/815.

KEY CONTACTS

GIOVANNI CAMPI
GOVERNMENT AFFAIRS ADVISOR

BRUSSELS
+32.2.336.1910
GIOVANNI.CAMPI@KLGATES.COM

KARISHMA SHAH PAGE
PARTNER

WASHINGTON DC
+1.202.778.9128
KARISHMA.PAGE@KLGATES.COM

ANDREW J. MASSEY
PARTNER

LONDON
+44.20.7360.8233
ANDREW.MASSEY@KLGATES.COM

DANIEL F. C. CROWLEY
PARTNER

WASHINGTON DC
+1.202.778.9447
DAN.CROWLEY@KLGATES.COM