Overview of the European Union (EU) new Corporate Sustainability Reporting Directive

On 21 April 2021, the European Commission published a proposal for a Corporate Sustainability Reporting Directive (CSRD), which will amend the existing Non-Financial Reporting Directive (NFRD).

The revised directive will support the European Green Deal, a set of policy measures intended to combat the climate crisis by transforming the EU into a modern, resource-efficient and competitive economy, with no net emissions of greenhouse gases by 2050. Furthermore, the directive is part of the bigger Sustainable Finance package, which enables the Green Deal by helping to channel private investment behind the transition to a climate-neutral economy.

The Sustainable Finance package includes the EU Taxonomy regulation (with the Climate Delegated Act), which provides clarification around the economic activities that most contribute to meeting the EU’s environmental objectives. In addition, the package features six amending Delegated Acts on fiduciary duties, investment and insurance advice, which will ensure that financial firms include sustainability in their procedures and investment advice to clients.
Who will the proposed directive apply to?

The scope of the proposed directive will be extended to apply to more entities.

First, it will apply to all companies listed on the EU regulated markets, except for micro companies. For listed small and medium-sized enterprises (SMEs) although they will fall within the scope, they will have until 1 January 2026 to comply with the reporting requirements.

Second, it will apply to a “large undertaking” that is either an EU company or a EU subsidiary of a non-EU company. A “large undertaking” is a defined term in the Accounting Directive and means an entity that meets two of the following three criteria:

- A net turnover of more than €40m
- Balance sheet assets greater than €20m
- More than 250 employees

As a third category, the CSRD will apply to insurance undertakings and credit institutions regardless of their legal form.

There are also exemptions to the application of the CSRD. Most notably, a subsidiary will be exempt if the parent company includes the subsidiary in its report that complies with the CSRD. As mentioned above, listed micro companies and non-listed SMEs fall outside of the scope, but can apply the provisions on a voluntary basis.

To respect the principle of proportionality, the European Commission will adopt mandatory sustainability reporting standards for large companies and separate, proportionate standards for SMEs. While SMEs listed on regulated markets will be required to use the proportionate standards from 1 January 2026, non-listed SMEs may still choose to use them on a voluntary basis.

Timescales

The 27 EU Member States will be expected to transpose the new directive into national law by 31 December 2022. As a result, companies that fall within the scope of the directive will need to comply with the amended rules for fiscal years beginning on or after 1 January 2023.

So that the reporting burden on affected SMEs is minimized, they will not need to start reporting in line with the directive until three years after its application, which is from 1 January 2026.

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1 Micro entities have fewer than 10 employees and an annual turnover or balance sheet below €2m.
2 Fewer than 250 employees and annual turnover below €50m or balance sheet below €43m.
3 Accounting Directive (Directive 2013/34/EU)
Context

The proposed Corporate Sustainability Reporting Directive aims to ensure that companies publicly disclose adequate information about the sustainability risks that they have and opportunities they face, as well as the impacts that they have on people and the environment (double materiality).

Reported information should be consistent with EU regulations, including the EU taxonomy, an EU-wide classification system that establishes a list of environmentally sustainable economic activities. According to the proposal, it should also be “comparable, reliable and easy for users to find and make use of with digital technologies.”

The proposal aims to reduce any unnecessary costs associated with sustainability reporting. Its goal is to enable companies to meet the growing demand for sustainability reporting in a cost-efficient manner.

The revised directive will amend four existing pieces of legislation:
- The Accounting Directive
- The Transparency Directive
- The Audit Directive
- The Audit Regulation

EU sustainability reporting standards

When companies report under the directive, they will need to use a set of new sustainability reporting standards being developed by the European Financial Reporting Advisory Group (EFRAG). EFRAG published a roadmap for developing these standards in March 2021 and will also develop supporting technical advice.

The proposed sustainability reporting standards will aim to meet the requirements of an inclusive range of stakeholders. They will adhere to the concept of “double materiality”, with both “impact materiality” and “financial materiality” perspectives being applied in their own right and without ignoring the interactions between them. The European Securities and Markets Authority (ESMA) will need to provide an opinion on the technical advice provided by EFRAG before the standards are adopted.

EFRAG’s proposals include a detailed roadmap for developing the new sustainability standards, as well as proposals for mutually reinforcing cooperation between the global and EU standard-setting initiatives. Given it looks set to become the EU sustainability reporting standard setter, EFRAG has also published recommendations for possible changes to its governance and funding, including a recommendation for a sustainability reporting pillar to be created alongside its existing financial reporting pillar.

The Commission aims to adopt a first set of sustainability reporting standards, developed by EFRAG, by 31 October 2022. This set will specify the information that companies should disclose with regard to reporting and sustainability, as well as any additional disclosure obligations for financial market participants.

Furthermore, the Commission aims to adopt a second set of reporting standards by 31 October 2023, with these standards specifying complementary sustainability information that companies should report on, including sector-specific considerations. The Commission will review the standards every three years after the directive has been applied, to take into account new developments such as international standards.

The EU sustainability reporting standards will contain guidance for companies on the process.
What does the proposed directive mean for companies?

The proposed Corporate Sustainability Reporting Directive marks a major step change in corporate reporting. It has far-reaching implications for businesses on an individual basis, as well as for the future of sustainability reporting, both in Europe and globally.

Companies, regulators, standard-setters and auditors will all need to devote significant time and resources to prepare for implementation of the directive – within a short timescale of less than two years.

Businesses will be required to disclose more sustainability-related information than ever before, potentially including information about their business models, strategy and supply chains. In addition, this information will either be assured by an external party for the first time, or more rigorously assured than it was before. The directive will therefore play an important role in helping to raise the bar globally when it comes to sustainability reporting.

The EY organization supports the long-term development of a comprehensive global framework for corporate reporting including a more robust set of reporting standards on sustainability matters. Developing a common European framework including a set of robust sustainability reporting standards is the only way to meet the market and social demands. Further steps toward greater levels of independent assurance are also important as sustainability information is increasingly used by all stakeholders in decision-making.

Furthermore, the introduction of EU-wide standards will give businesses less flexibility about what information they disclose, and how they disclose it. Instead the information they provide will be comparable with the information provided by their peers. Since investors will inevitably use this comparability to inform their decision-making, companies should increasingly expect capital to flow toward companies that can authentically demonstrate a strong sustainability performance.

In the long term, the directive could stimulate changes in tax policy as governments use sustainability information reported by companies as the basis for developing incentives. The directive could also transform the way in which businesses approach their own decision-making processes and how they share their stories with their stakeholders.

Preparation

Given the significance of the directive – and the time it may take to get ready for it – companies will want to start preparing for its
implementation from the beginning of 2022 when the draft standards will be made available for public consultation. Not only will they want to familiarize themselves with the proposal itself, they will also want to consider what its requirements mean for their business on a practical level.

It is the responsibility of the board to ensure that the management team sufficiently prepares the company for the implementation of the new directive, with planning beginning straightaway. While the board will provide general oversight of the company’s preparations, the audit committee also has an important role to play. It should oversee any new measuring and reporting processes that are established, and monitor the effectiveness of systems and controls set up to help ensure the robustness of the information produced.

CFOs, their finance teams and other colleagues across their businesses have a lot of work to do to prepare for the implementation of the new directive. They need to understand what it means for their processes and controls, and assess whether any additional training is required.

Effectively, the directive will require companies to embark on a major change management exercise internally and shift the mindsets of key personnel to attribute as much importance to the reporting of non-financial information as they currently do to the reporting of financial information.

Companies will need to consider how they identify and gather sustainability-related information, manage environmental, social and governance risks, draw up policies, and set targets and KPIs. This may even be an opportunity to reassess whether those targets and KPIs are still relevant or in need of revision.

Additional due diligence on companies’ supply chains and a review of the effectiveness of their internal quality control and risk management systems may also be performed. Inevitably there will be challenges associated with reporting on intangible assets such as reputation and human capital.

Risk management is another key consideration. To ensure that they meet their obligations under the new sustainability reporting standards, companies will need to establish efficient procedures, adapt internal controls and ensure appropriate governance and monitoring is in place.

Furthermore, companies should review their arrangements regarding the external assurance of their sustainability information.

Since the sustainability reporting standards are still in progress, companies will need to embark on their preparations without having certainty around what they are actually preparing for. For this reason, companies should remain abreast of any outcomes, interpretation and communications from EFRAG during the standard-setting process so that they can get early visibility of how the standards are likely to look.

Costs

It is expected that 49,000 companies will be required to report sustainability information in future, compared with 11,600 companies at present. While the EU’s proposal aims to “reduce the unnecessary costs of sustainability reporting for companies” it is estimated that preparers will incur significant one-off costs as well as recurring annual costs to comply with the directive. Nevertheless, the proposal highlights that companies already faced a growing bill to provide sustainability information due to stakeholder demand. As a result, companies could effectively save by using the standards, depending on their size, on the basis the standards remove the need for additional information requests. The costs and savings will differ from company to company and depends on the size and complexity of the business they are operating in.

SMEs

Listed SMEs will only be expected to provide sustainability reporting that is proportionate to their size and resources. As a result, the sustainability reporting standards will set out the information they need to disclose and how they should disclose it. Embarking on sustainability reporting will inevitably be a big step for SMEs that have never done it before. They may find it useful to seek professional expertise from external partners, to support them with the transition.

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Footnote 4: Data extracted from the Impact Assessment issued by the European Commission on 21 April 2021 with specific reference to Annex 17: Cost Analysis performed by the Centre for European Policy Studies (CEPS) Non-financial reporting by large companies (updated rules) (europa.eu)
What will companies need to do in practice?

Companies that fall within the scope of the proposed Corporate Sustainability Reporting Directive will need to make some significant changes to how they prepare and disclose sustainability information.

Management will need to:

1. Provide additional disclosures

Companies will be required to disclose:

- Information about their business strategy – and the resilience of their business model and strategy in the face of sustainability-related risks
- Any plans they may have to ensure their business model and strategy are compatible with the transition to a sustainable and climate-neutral economy, and with limiting of global warming to global warming in line with the 2015 Paris Agreement
- Whether and how their business model and strategy take account of the interests of stakeholders
- Any opportunities arising from sustainability that the company may be able to seize
- How implementation of the business strategy is likely to affect, or be affected by, sustainability matters
- Any sustainability targets that they have set themselves – as well as their progress toward achieving these targets
- A description of their sustainability policies
- The role of the board and management in relation to sustainability matters
- The principal actual and potential adverse impacts associated with the company’s activities, including impacts linked to its value chain
- Any actions taken, and the result of such actions, to prevent, mitigate or remediate actual or potential adverse impacts associated with the company’s value chain
- A description of the principal risks that the company faces in relation to sustainability matters, including its principal dependencies and how it manages those risks
2. Report in accordance with new sustainability reporting standards

Companies will use the new sustainability reporting standards to disclose the following information as part of their management report, thereby giving users of the report an integrated view of their impact and performance:

- All major environment-related matters that affect their businesses, including their impacts and dependencies on climate, air, land, water and biodiversity
- Any physical risks they face, as a result of the environment, as well as risks associated with the transition to a carbon-neutral economy
- Their resilience to different climate scenarios
- The level and scope of their greenhouse gas emissions and removals, including the extent to which they use offsets and the source of those offsets
- Energy use and energy efficiency
- Social considerations, including equal opportunities, training and skills, working conditions, human health and human rights
- Governance, including information on the role and composition of the company’s administrative, management and supervisory bodies
- Internal control and risk management systems, including those that relate to the reporting process
- Culture and approach to business ethics, including anti-corruption and anti-bribery, political engagement and lobbying activity
- The company’s management and the quality of its relationship with business partners, including payment practices

All sustainability information disclosed should apply a forward-looking and retrospective view, and should be qualitative and quantitative. It should also take into account short-, medium- and long-term horizons and consider the company’s whole value chain, including its operations, products and services, business relationships and supply chain.

3. Use digital tagging

Technology plays an important role in measurement, standardization and management of sustainability matters and data should be considered from the start. The digitalization of sustainability matters rationalizes the analyzes of data provided by all the stakeholders and avoids the proliferation of different formats. Companies will need to rapidly enhance the systems of internal control over sustainability matters, and a digital-first approach should be used to streamline and automate sustainability processes, while providing greater levels of auditability and traceability.

To make their sustainability information easier for users to search via the upcoming European Single Access Point (ESAP) and machines to read, companies will be required to prepare both their financial statements and their management report in a single XHTML format and mark up sustainability information. The information reported will need to be tagged in accordance with a digital taxonomy.
Audit committees will have enhanced responsibilities under the new directive. They will need to:

- Monitor the company’s sustainability reporting process, including the digital reporting process, and the process that the company followed to identify the information reported in line with the sustainability reporting standards
- Submit recommendations or proposals to ensure the integrity of the sustainability information provided by the company
- Monitor the effectiveness of the company’s internal quality control and risk management systems and, where applicable, its internal audit function, with regard to the reporting of sustainability information, including digital reporting
- Monitor the assurance of annual and consolidated sustainability reporting
- Inform the company’s administrative or supervisory body of the outcome of the assurance of sustainability reporting
- Explain to the administrative or supervisory body how it contributed to the integrity of sustainability reporting and what role it played in that process
- Review and monitor the independence of the statutory auditors or audit firms

Role of auditors

Under the existing NFRD, there is no systematic requirement for companies to provide external assurance around their sustainability information. This is in stark contrast to their financial information, which is assured by their statutory auditor. In its proposal, the European Commission notes that the “objective is to have a similar level of assurance for financial and sustainability reporting.” Nevertheless, at present, the absence of a commonly agreed standard for the assurance of sustainability reporting raises the risk of misunderstandings and differing expectations around how sustainability information could reasonably be assured.

As a result, the Commission is adopting a “progressive approach” to enhancing the level of assurance required for sustainability information. Under the proposed directive, there will be a requirement for the company’s statutory auditor, or an independent assurance services provider, to provide limited assurance around a company’s reported sustainability information. There will be the option of moving toward reasonable assurance – the standard of assurance provided for financial information – at a later stage.

For limited assurance, the opinion of the statutory auditor, or independent assurance services provider, should cover the following:

- Whether the company has complied with the EU sustainability reporting standards
- The process that the company followed to identify the information that it disclosed under the standards
- Whether the company complied with the requirement to mark up its sustainability reporting
- Whether the company’s reporting complied with the requirements of Article 8 of the Taxonomy Regulation

All providers of assurance around sustainability information will need to be subject to the same high level of standards, qualifications, objectivity, independence, ethics, quality assurance and oversight that statutory auditors of financial statements are subject to currently.

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1 Mandatory assurance is requested in France, Italy and Spain
2 Sustainable finance taxonomy – Regulation (EU) 2020/852
Oversight and enforcement

EU Member States will be required to extend their current frameworks for providing public oversight of statutory auditors and audit firms to cover assurance of sustainability reporting. The proposal also recommends that Member States establish a system of quality assurance review for assurance of sustainability reporting, as well as an investigations and sanctions regime for statutory auditors and audit firms that provide this service. The individuals within the company who are responsible for the annual report will be required to confirm, to the best of their knowledge, that the management report is prepared in accordance with the sustainability reporting standards. The proposal also calls for Member States to apply sanctions and other measures where sustainability reporting requirements have been infringed.

In brief

Since affected companies – except for SMEs – are expected to report under the directive for fiscal years beginning on or after 1 January 2023, they only have a limited period of time to prepare for its implementation. As a result, it is essential they start taking action now to understand the impact of the directive on their sustainability strategy, as well as its impact on their corporate reporting, internal controls and other key business processes.

EY multidisciplinary teams are able to help companies and their stakeholders – including investors, policy-makers and regulators – understand the directive and prepare for the huge changes it requires. These skilled teams incorporate a wide range of experience, from audit and assurance, corporate reporting, corporate governance, internal audit and tax through to climate change and sustainability, digital transformation and people advisory services. They can help companies to identify their core sustainability issues, along with the associated risks and opportunities, and develop strategies that create long-term value for their own businesses, as well as society at large.

EY team have considerable experience of helping companies to implement largescale corporate reporting transformation in the past, having previously helped clients to adopt the NFRD. In addition, The EY organization has already undertaken limited assurance on information reported under the NFRD in France, Italy and Spain, since these countries required it. EY is committed to innovation, and improving the disclosure practices of businesses to provide more reliable and accurate information in relation to sustainability matters. EY digital audit platforms also provide market-leading solutions for the automation and assurance of sustainability information.
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