In the loop

March 2022

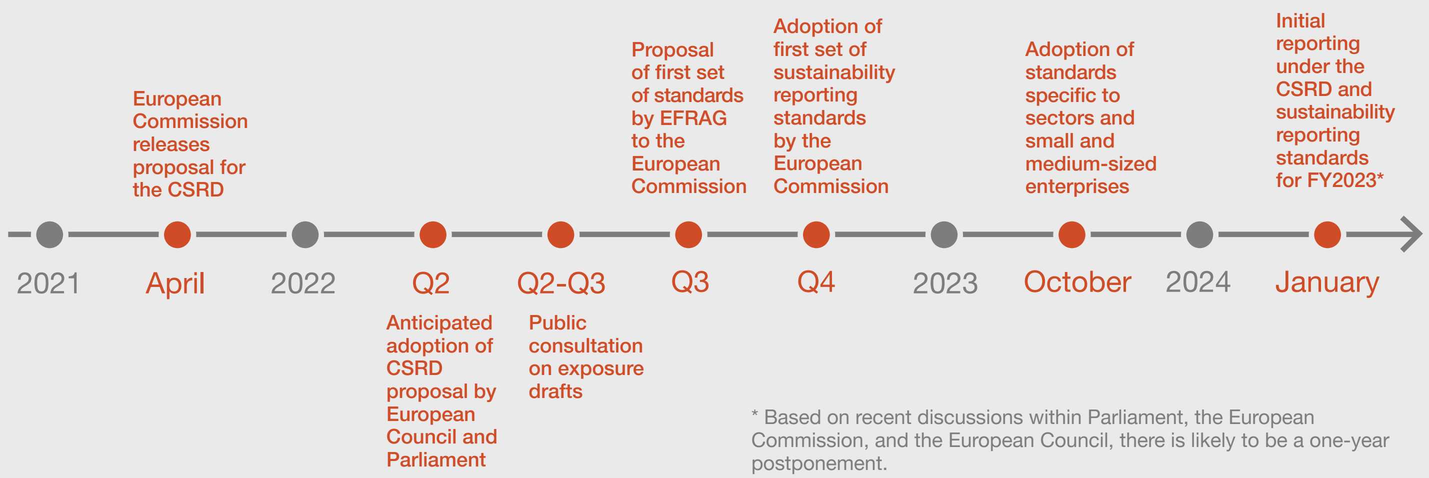
Why US companies should not ignore Europe's ESG proposals

The European Commission is addressing corporate behavior through its Sustainable Finance agenda. US companies will be affected by the proposed ESG reporting regulation if they have subsidiaries in Europe. This is not by mistake but by design. It's time to get ready.

Stakeholders around the world are calling for management to be transparent about strategies to build a sustainable future for individual companies and the planet. In the US, companies are evaluating the SEC's March 21 proposal on climate change disclosures. But US companies singularly focused on US regulations will find themselves unprepared if they are scoped into global ESG reporting requirements.

In Europe, a proposed corporate sustainability reporting regulation is expected to impact nearly 50,000 entities - more than four times as many entities as are reporting under the current European Union (EU) requirements. By requiring more entities to include mandatory sustainability disclosures, including information about targets and progress toward achieving them, the Corporate Sustainability Reporting Directive (CSRD) aims to drive changes in companies' behavior and bring sustainability reporting on par with financial reporting over time.

While this might sound to be of little consequence to US companies, the far-reaching scope of the CSRD will have a more significant impact than one might expect at first glance. EU subsidiaries of US companies may be required to provide substantial incremental ESG disclosures that will shed more light into a company's ESG strategy, targets, and progress, as well as its products and services, business relationships, and supply chain. It's a lot more than just a simple compliance exercise.



* Based on recent discussions within Parliament, the European Commission, and the European Council, there is likely to be a one-year postponement.

> ...problems in the quality of reporting create an accountability gap. High quality and reliable public reporting by companies will help create a culture of greater public accountability.
>
> European Commission, Questions and Answers: Corporate Sustainability Reporting Directive proposal

Casting a wider net to effect change

The provisions of the EU's current reporting requirements, the Non-Financial Reporting Directive (NFRD), have been in effect in all EU member states since 2017 and require large listed entities, banks, and insurance companies with more than 500 employees to disclose information about their environmental and social impacts. These requirements have had limited impact on US companies doing business in the EU because these companies were generally not in scope as the NFRD largely only applied to entities with securities trading in an EU-regulated market. Then enters the European Green Deal, a December 2019 European Commission commitment to achieving climate-neutrality by 2050 and protecting Europe's natural habitat. As part of this initiative, and in response to criticism from investors and other stakeholders, the European Commission announced its intention to review the NFRD with two objectives: (1) enhance reporting to investors and other stakeholders to strengthen the foundations for sustainable investment and (2) motivate companies to mitigate climate change.

The April 2021 proposal—the CSRD—would require companies in its scope to report on how sustainability issues affect their business and the impact of their activities on people and the environment. EU subsidiaries of US companies are more likely to be captured in the scope of the CSRD compared to the current rules because the requirements for reporting are based on the size of the company.

The CSRD disclosure requirements will be detailed in new European Sustainability Reporting Standards that are being developed by the European Financial Reporting Advisory Group (EFRAG). EFRAG has historically advised the European Commission on the endorsement of IFRS. The required disclosures would cover the entire spectrum of E, S, and G (e.g., climate change mitigation, workforce, business ethics, political engagements) and information about a company's value chain. In January, EFRAG began releasing working papers for certain standards (drafts of the exposure drafts) and additional papers have followed. The working papers are not open to public consultation but are intended to preview the content expected to be released for comment in late April. Based on the initial working papers, a significant amount of quantitative and forward-looking information would be required.

Finalization of the CSRD is subject to approval by the European Parliament and European Council, which we expect in mid 2022, and transposition into national law by member states. These two parties plus the European Commission must reach a consensus before the CSRD is approved, and key points continue to be debated. As a result, all provisions of the CSRD discussed herein are subject to change.

Stay ahead of the curve: key requirements of the CSRD

We've addressed some of the questions that may be top of mind as you assess whether the CSRD as currently proposed would impact your company.

What companies are expected to be in the scope of the CSRD?

As currently drafted, the CSRD would be mandatory for:

- all companies listed on EU-regulated markets (with certain limited exceptions) and
- all large EU companies, defined as exceeding at least two of the following metrics on two consecutive annual balance sheet dates:

Total assets	Net turnover (revenue)	Average number of employees during fiscal year
€20m	€40m	250
(about $22.6m as of 12/31/21)	(about $45.3m as of 12/31/21)	

Subsidiaries that are not in scope on a standalone basis would also need to be assessed to determine if they are part of a "large group" that would fall within the scope of the rules. Large (as defined) EU subsidiaries of companies headquartered outside the EU would be required to comply with the new rules, which is a critical consideration for multinational companies based in the US. Group reporting would include all entities legally owned by those subsidiaries even if registered outside the EU.

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The EU commitment and contribution to international compatibility and convergence has been a clear goal for EFRAG since the beginning [...].

EFRAG Project Task Force on European sustainability reporting standards (PTF-ESRS) status report, November 2021

Would there be any exceptions?

One main one. As currently proposed, subsidiaries may be exempt from separately reporting under the sustainability reporting requirements of the CSRD if they are included in the consolidated “management report” of a parent entity that is prepared “in a manner that may be considered equivalent” to the European Sustainability Reporting Standards developed under the CSRD. (A management report accompanies the financial statements and is roughly equivalent to MD&A.)

Although it’s still unclear how equivalency will be determined, given that the objective of the CSRD is not just to provide better information to stakeholders, but also to encourage companies to adjust their business models to reduce their environmental impact, it is unclear if the SEC climate disclosure requirements proposed on March 21 would qualify as the rules are not final and equivalency has not been determined (see our In brief on the proposal). As a result, EU subsidiaries within the scope of the CSRD should be prepared to comply with the new requirements unless a parent entity (e.g., an EU holding company or a non-EU parent) is preparing reports that are equivalent to—or the same as—the EU requirements.

It remains to be seen whether companies will be required to prepare separate reports for each entity within the scope of the CSRD, or if some type of combined or consolidated reporting will be permitted. Companies would be well served to understand what information would be needed to report at various levels.

What sustainability disclosures would be required under the CSRD?

In developing the European Sustainability Reporting Standards, EFRAG’s objective is to build upon existing standards and frameworks while remaining consistent with the ambition of the European Green Deal and with EU regulations. In developing the proposed standards, EFRAG is collaborating with international organizations to share technical expertise, such as through its Statement of Cooperation with the Global Reporting Initiative (GRI), who in turn has agreed to collaborate with the International Sustainability Standards Board to provide “compatibility and interconnectedness of investor-focused baseline sustainability information that meets the needs of the capital markets, with information intended to serve the needs of a broader range of stakeholders.”

As of March 31, EFRAG has issued more than 20 working papers, including overarching standards that address disclosures on sustainability matters that relate to a company’s strategy and business model, its governance and organization, and its materiality assessment, as well as two conceptual guidelines on “double materiality” and “characteristics of information quality.”

The planned reporting structure for these standards includes 19 “sector-agnostic” standards:

4 standards

addressing strategy, governance, impacts, risks and opportunities (e.g., sustainability governance & organization)

5 standards

addressing the environment (e.g., pollution, water & marine resources)

7 standards

related to social (e.g., own workforce, affected communities, consumers / end users)

3 governance standards

(e.g., responsible business practices)

They also plan to have 1 on presentation and additional sector-specific standards to provide “maximum relevance.” Based on the working papers released to date, the proposed disclosures would be more robust than current reporting by US companies. The level of detail that would be required is consistent across working papers, and examples of some of the (potentially) more challenging areas are provided to demonstrate the depth of the requirements.

The climate change working paper describes disclosure requirements that include the following:

- An analysis of the resiliency of a company’s strategy and business model in response to climate-related risks
- A scenario analysis to identify physical and transition risks over short, medium, and long-term timeframes
- A description of governance of climate-change matters, including use of internal carbon pricing programs and climate-related targets as part of compensation
- The company’s policies and action plans for climate change mitigation (limiting the increase in global average temperature as laid out in the Paris Agreement) and adaptation (adjusting to actual and expected climate change and its impacts)
- Measurable climate-related targets (including greenhouse gas (GHG) emissions reduction targets for 2025 and preferably every five years thereafter, but at least including target values for the years 2030 and 2050)
- Performance measures, including Scope 1, 2, and 3 GHG emissions, and GHG emissions per dollar of net revenue (GHG intensity)
- Financial exposures to physical and transition risks and the potential impact on future financial performance
- Reconciliations of amounts used to calculate metrics to the amounts included in the financial statements

The working paper on biodiversity and ecosystems describes disclosure requirements that go well beyond current best practice. For example, it discusses “no net loss” and “net gain” targets from a biodiversity perspective by 2030 and 2050, respectively. “No net loss” refers to avoiding or mitigating the impacts a project or plan has on biodiversity.

It may be challenging for companies to accumulate the necessary data and implement appropriate processes to support its reliability given the volume and nature of the disclosure requirements laid out in the working papers, particularly if reporting is done at a subsidiary level as proposed.

> Companies that are required to report against standards will have to identify and report on their most significant non-financial risks, dependencies and impacts, and explain how they manage them. This discipline will have an indirect beneficial effect on the environment, society and fundamental rights, to the extent that it affects company decisions and the way companies behave.
>
> Impact assessment on Proposal for a Revision of the Non-Financial Reporting Directive, Commission Staff Working Document

When would the detailed requirements be effective?

EFRAG expects to begin public consultation in late April 2022. Following due process, the first set of draft standards is likely to be ready in late 2022. As currently proposed, companies would be expected to report on 2023 information as early as 2024; however, there is ongoing discussion between the European Council, the European Commission, and the Parliament of a possible one-year postponement of first-time application of the CSRD.

Even if implementation is postponed by a year, companies will not have a lot of time to develop the necessary processes and controls. As such, leading practice would be to begin developing an implementation plan now based on the initial proposals.

How would materiality be assessed?

The proposed CSRD includes the concept of "double materiality," which requires that companies report information necessary to understand:

1. the impact the company has on sustainability matters, including environmental, social, and employee matters, respect for human rights, anti-corruption and bribery matters, and governance (inside-out perspective), and
2. how sustainability matters affect the company's development, performance, and position (outside-in perspective)

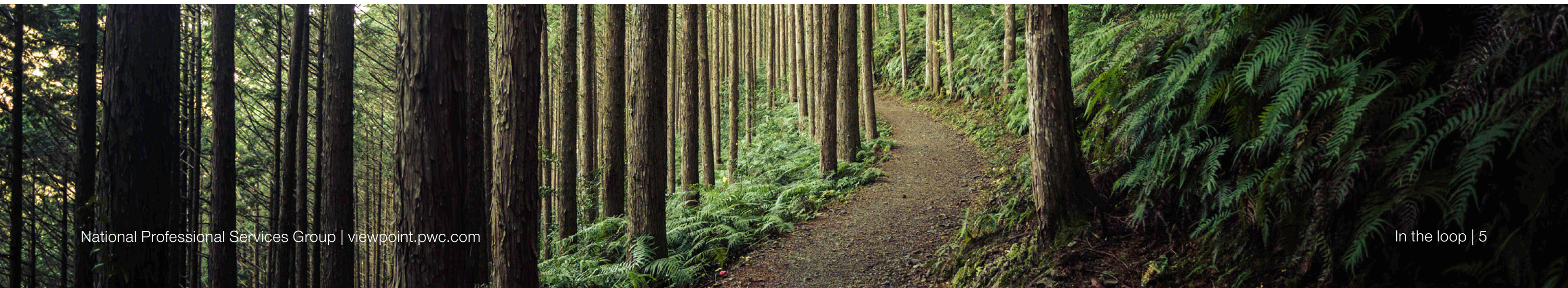
According to language in the proposed CSRD, companies would need to consider each materiality perspective in its own right, and then disclose information necessary to understand how sustainability matters affect them, and information necessary to understand the impact they have on people and the environment. Key concepts and additional guidelines to facilitate how companies apply double materiality are described in the working paper on sustainability material impacts, risks and opportunities.

Would third-party assurance be required?

Yes. The proposed CSRD imposes a mandatory assurance obligation for reported sustainability information. The proposed directive would initially require "limited assurance," which is a negative form of assurance that states that no matter has been identified by the auditor to conclude that the subject matter is materially misstated. However, the European Commission intends to review the CSRD after three years to determine whether the requirement should be expanded to "reasonable assurance," which would require more extensive procedures, including consideration of internal controls of the company and substantive testing. This is a significant change from the current state of play, as the audit requirement under the NFRD is limited to the "existence" of disclosures, with no mandatory audit requirement of the content.

As drafted, the assurance services would be able to be provided by the company's statutory auditor or potentially any other accredited independent assurance services provider, as long as they are subject to the same rigorous professional and independence standards.

In addition, the audit committee would be expected to be responsible for sustainability reporting covering, for example, the monitoring of the sustainability reporting process, including the effectiveness of the company's internal quality control and risk management systems.



What's next?

Given the relatively short time frame to develop and implement the systems, data, and processes necessary to comply with the requirements of the CSRD once they are finalized and the uncertainty about equivalency of the proposed SEC requirements, we recommend that companies address the following questions to begin assessing the implications of the anticipated new rules based on the proposal as currently drafted.

Current state assessment	• What subsidiaries are in scope of the CSRD? • Are there changes needed to current processes and controls in anticipation of the new European Sustainability Reporting Standards? • What are the data requirements under the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations and GRI standards, which will be leveraged in developing the European Sustainability Reporting Standards? • What information is currently being produced that may support some of the expected requirements?
Strategy development	• How does the company's current ESG strategy align with the objectives of the CSRD? • At what level of the organization should reporting requirements be applied? • How can a compliance requirement be expanded to maximize value creation for stakeholders by developing and executing a sustainable business model?
Process, controls and governance	• What processes and controls will be needed to report current period information and forward looking information that will be subject to assurance requirements? • Do current processes allow for sustainability reporting at the level of detail required by CSRD (i.e., subsidiary-level reporting)? • Is there a monitoring mechanism in place to ensure the interplay of requirements between the CSRD and the proposed SEC rules is being considered in determining the company's approach to compliance?

In reality, exactly what's next remains to be seen, but it's clear big changes are coming. The next several months will be an inflection point for climate-change reporting as stakeholders debate and discuss the proposed rules from the SEC, the CSRD, and the International Sustainability Standards Board. The scope and breadth of the proposed standards reflect the demand from investors for additional information. And, even companies not directly captured by the new rules will see amplified demand for enhanced transparency related to ESG impacts and priorities. Now is the time to strategize, assess, and plan for the additional disclosures that may be needed.

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