In the loop

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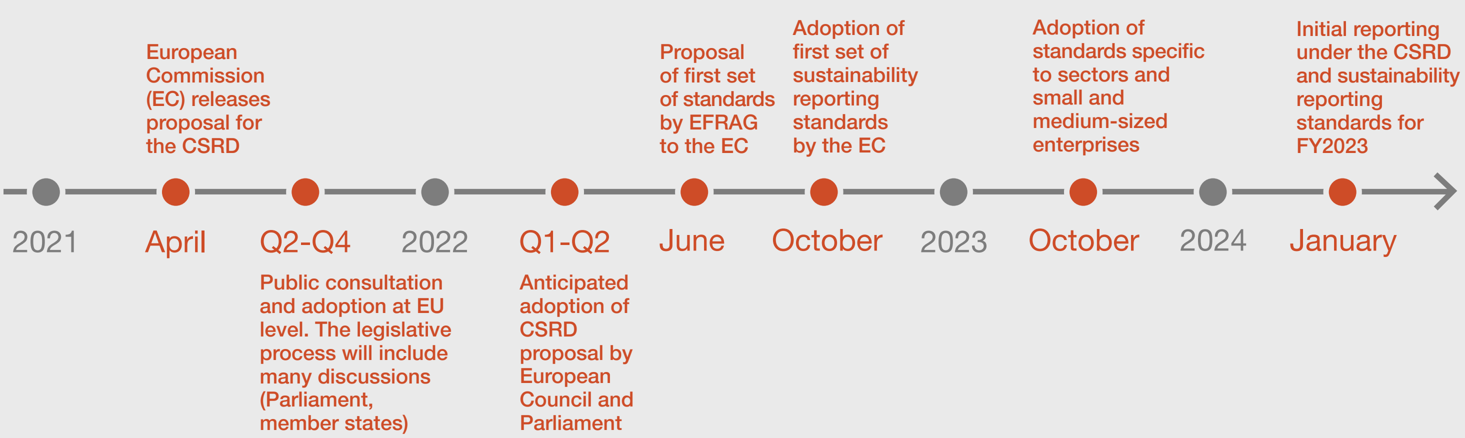
Make no mistake – global ESG regulations will impact US companies

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.

Pressure from stakeholders around the world is compounding daily. They are calling for management to be transparent about strategies to build a sustainable future for individual companies and the planet. In the US, companies await the SEC's 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 in the European Union (EU) is expected to impact nearly 50,000 entities – more than four times as many entities as are reporting under the current EU requirements. By requiring more entities to include mandatory sustainability disclosures, including about targets and target achievements, the Corporate Sustainability Reporting Directive (CSRD) aims to drive changes in companies' behavior and bring (over time) sustainability reporting on par with financial reporting.

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.



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> ...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 had limited impact on US companies doing business in the EU as SEC reporting requirements largely fulfilled the NRFD requirements for affected entities. Then enters the European Green Deal, a December 2019 European Commission (EC) commitment to achieving climate-neutrality by 2050 and protecting Europe's natural habitat. As part of this initiative, the EC 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.

In response to criticism from investors and other stakeholders that the information provided under the NFRD lacks comparability, reliability, and relevance, the EC proposed the CSRD in April 2021 with the intent of improving and enhancing the existing rules to better meet investor needs and bringing sustainability reporting on par with financial reporting.

The CSRD will require companies that are in scope to report on how sustainability issues affect their business and the impact of their activities on people and the environment. The disclosure requirements will be detailed in new European Sustainability Reporting Standards, which are under development. The requirements will be much more robust than much of the current reporting in this area. EU subsidiaries of US companies are more likely to be captured in the scope of the CSRD as the requirements for reporting are based on the size of the entity, whereas the NFRD largely only applied to entities with securities trading in an EU-regulated market.

Finalization of the CSRD is subject to approval by the European Parliament and European Council, and transposition into national law by member states, which we expect in mid 2022. 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 will impact your company.

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

As currently drafted, the CSRD will 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 balance sheet dates:

Total assets
€20m
(about $22.6m as of 12/31/21)

Net revenue
€40m
(about $45.3m as of 12/31/21)

Average number of employees during fiscal year
250

Large (as defined) EU subsidiaries of companies headquartered outside the EU will be required to comply with the new rules, which is a critical consideration for multinational companies based in the US.

"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

Will 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 unlikely that current US SEC requirements, or even the soon-to-be proposed SEC climate disclosure requirements, would qualify. As a result, unless an EU holding company or non-EU parent is preparing voluntary reports on par with the EU requirements, we expect that EU subsidiaries within the scope of the CSRD will be required to comply with the new requirements.

US companies should consider whether they want to report separately for each of their EU subsidiaries that are in the scope of the CSRD (including all entities legally owned by those subsidiaries even if registered outside the EU). Alternatively, they could elect to implement the requirements at a higher level within the organization.

What sustainability disclosures will be required under the CSRD?

The draft CSRD itself does not provide detailed disclosure requirements, except to propose that the information be included as part of the management report. It does set the tone that the information will need to be robust and quantitative. Specific standards are under development by the European Financial Reporting Advisory Group (EFRAG), which has historically advised the EC on the endorsement of IFRS.

In developing the European Sustainability Reporting Standards, EFRAG's objective is to build upon existing standards and frameworks, including those of the Task Force for Climate-Related Financial Disclosures (TCFD) and Global Reporting Initiative (GRI), while remaining consistent with the ambition of the European Green Deal and with EU regulations. Collaborating with international organizations to share technical expertise, such as through its Statement of Cooperation with GRI, who in turn has agreed to collaborate with the Sustainability Accounting Standards Board (SASB), will bolster this objective.

Although the detailed requirements have not yet been developed, the CSRD specifies that the following will be the key components of the European Sustainability Reporting Standards, which will be designed to cover the whole of a company's value chain and the entire spectrum of E, S, and G (e.g., climate change mitigation, workforce, business ethics, political engagements):

1	brief description of the business model and strategy
2	targets related to sustainability matters set by the company and progress made towards achieving those targets
3	role of the administrative, management and supervisory bodies
4	policies in relation to sustainability matters
5	principal risks and management of those risks
6	indicators relevant to disclose information referred to in points 1 to 5
7	intangibles: intellectual, human, social and relationship capital
8	process carried out to identify the information included in the management report and taking account of short, medium and long-term horizons

When will the detailed requirements be effective?

EFRAG has been working over the past six months to draft a number of working papers that it expects to begin public consultation on in early 2022. Following due process, the first set of draft standards is targeted to be ready by mid-2022. As currently proposed, companies will be expected to report on 2023 information as early as 2024. An early indication on where the standards may be heading is available through an EFRAG working paper, which speaks to requiring disclosures on climate reduction targets through 2030 and then every five years up to 2050.

In the greater scheme of financial reporting, this will not present a lot of time to develop the necessary processes and controls. Leading practice would be to begin developing an implementation plan now based on the initial proposals.

> "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

How will 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 business development, performance and position (outside-in perspective)

According to language in the proposed CSRD, companies will need to consider each materiality perspective in its own right, and they should disclose information necessary to understand how sustainability matters affect them, and information necessary to understand the impact they have on people and the environment.

How companies will apply the materiality concepts is not stated in the proposed CSRD. As a result, uncertainty exists around how companies will make this assessment until more guidance is provided.

Will 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 EC intends to review the CSRD after three years to determine whether the requirement should be expanded to "reasonable assurance," which would require extensive procedures, including consideration of internal controls of the company and substantive testing, and is therefore a higher level of effort than in a limited assurance engagement. 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.

The assurance services will 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 is 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, 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 TCFD and GRI standards, which will be leveraged in developing the European Sustainability Reporting Standards?

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)?

In reality, exactly what's next remains to be seen, but it's clear big changes are coming. While the CSRD wants to drive fundamental change in corporate behavior, investors' belief in the usefulness of ESG information has also been a strong motivator for enhanced disclosure. Yes, some subsidiaries of US entities will be captured in the scope of the CSRD, but those new robust disclosure requirements will also amplify calls for all companies to enhance transparency related to ESG impacts and priorities. Stakeholders in fully domestic companies could expect parity across their portfolio. Now is the time to strategize, assess, and plan for the additional disclosures that may be needed.

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