What's CSRD? You should already know

> "Sustainability reporting will now be on an equal footing with financial reporting. The [CSRD] will help drive the transition to a sustainable economic system built on innovation and investment opportunities.
>
> Mairead McGuinness
>
> European Commissioner for Financial Services, Financial Stability and Capital Markets Union
>
> June 22, 2022

Stakeholders around the world continue to call for transparency about companies' environmental, social, and governance risks and opportunities. In the US, the SEC is currently evaluating feedback on its March proposal on climate disclosures. But companies may have to contend with more than the proposed SEC requirements. In June, the European Council and European Parliament took steps to ensure that European Union (EU) ESG regulations will be a reality, reaching a provisional agreement that includes the scope and timeline for adoption of EU ESG reporting requirements that are expected to affect companies worldwide.

The EU regulations are part of the Corporate Sustainability Reporting Directive (CSRD), which will impact many more entities than are reporting under current EU non-financial reporting requirements, including certain US and other non-EU companies and their EU subsidiaries. By requiring more entities to provide mandatory sustainability disclosures, the CSRD is designed to drive changes in company behavior and bring sustainability reporting on par with financial reporting over time.

Determining whether a company or its subsidiary is captured by the scope of the proposed rules has some complexity. And even once in scope, the need to report at a global consolidated level, the standards required, and the effective date differ depending on the particular circumstances. What is clear, though, is that reporting could begin as early as fiscal year 2024, and the requirements are extensive.

The CSRD goes well beyond both the climate-related risk disclosures that would be mandated by the SEC's proposal and today's non-financial reporting requirements in the EU. Companies that fail to appreciate the impact of the new requirements will find themselves scrambling to comply.

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Stay ahead of the curve: key requirements of the CSRD

> European consumers … will now be better informed about the impact of business on human rights and the environment… Greenwashing is over.
>
> Bruno le Maire
>
> European Council Minister for economic affairs, finance and industrial and digital sovereignty
>
> June 21, 2022

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. Then enters the European Green Deal, a December 2019 European Commission package of policy initiatives designed to achieve climate-neutrality by 2050 and protect Europe's natural habitat. As part of these initiatives, and in response to demands 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 operating in the EU to mitigate climate change.

In June, the European Commission, the European Parliament and the European Council reached political agreement on the provisions of the CSRD. Now that this significant step has been reached, the text of the CSRD will be subject to legal and technical review, which may lead to minor changes. The European Parliament and European Council need to formally approve it, which is expected later this year. After approval and publication in the Official Journal, Member States will have 18 months to incorporate the CSRD into their own national laws. During this process, Member States may make changes, potentially to significant areas, such as scope.

The CSRD would require comprehensive and granular disclosures about how sustainability issues affect a company's business, as well as the impact of the business' activities on people and the environment (so called "double materiality"). This contrasts with the SEC's narrower concept of materiality, which is based on information that is material to investors. And whereas the SEC's proposed disclosures are specific to climate, the CSRD's required disclosures are broader, covering the entire spectrum of sustainability topics (e.g., climate change, biodiversity and ecosystems, working conditions, human rights, business ethics). These disclosure requirements will be detailed in new European Sustainability Reporting Standards (ESRS) that are being developed by the European Financial Reporting Advisory Group (EFRAG), which has historically advised the European Commission on the endorsement of IFRS.

The following pages provide answers to the questions that we expect are top of mind as companies consider the CSRD and assess how, or if, it would impact their organization.

What determines if a multinational company is in the scope of the CSRD?

The provisional agreement reached in June confirmed many of the substantive principles of the CSRD proposed in April 2021. While the scope provisions have changed, they remain broad, and are intended to apply to many companies operating in the EU. Even companies without reporting obligations under the CSRD may be asked for information by customers, suppliers, investors, or lenders because of the requirements for entities in scope to disclose information about their value chain, or because they are subsidiaries of EU companies with reporting obligations.

The CSRD may apply to US and other non-EU companies in the following ways.

A multinational company would be required to report at the subsidiary level if the subsidiary meets either of the following criteria:

- It has debt or equity securities listed on an EU-regulated market
- It is a "large undertaking," defined as exceeding at least two of the following metrics on two consecutive annual balance sheet dates:
  - Total assets of €20 million or more (about $21 million as of June 30)
  - Net turnover (revenue) of €40 million or more (about $42 million as of June 30)
  - Average of 250 or more employees

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.

A multinational company would be required to provide reporting for the global consolidated entity if the parent company has debt or equity securities listed on an EU-regulated market.

In addition to the subsidiary reporting requirements, reporting would be required for a US or non-EU company at a global consolidated level if its consolidated net turnover (revenue) generated in the EU exceeds €150 million (about $157 million as of June 30) for each of the last two consecutive fiscal years *and* has one of the following:

- at least one "large" subsidiary in the EU or a subsidiary listed on an EU-regulated exchange, or
- at least one branch that generates revenue of €40 million (about $42 million as of June 30) or more in the preceding year.

The analysis to assess whether a company is in scope of the CSRD (and the level at which it would be required to report) may be complex and need input from a company's legal counsel.

Companies would be permitted to prepare combined reports in limited instances, and may be able to satisfy their subsidiary reporting requirements by reporting at a higher level within the organization. Assessing what information would be needed in order to report at various levels would be a worthwhile exercise as companies determine if (and how) they need to report.

The appendix includes examples of some of the more common structure and size scenarios and summarizes the related requirements and effective dates.

What reporting standards would an in-scope company apply?

Adding to the complexity, companies scoped into the CSRD will not all apply the same standards. Which of the three types of reporting standards would need to be applied depends on the circumstances:

- *European Sustainability Reporting Standards*: As detailed below, 13 standards have been released in draft for public comment.
- *Non-EU dedicated standards*: These are dedicated standards to be applied at a global consolidated level by certain companies in scope in countries outside the EU (e.g., the US).
- *Simplified standards*: These are for use by certain small and medium-sized enterprises (SMEs), small and non-complex institutions, and captive insurance undertakings, as defined in EU regulation.

The simplified standards have yet to be developed, but we expect the process to begin in late 2022 or early 2023. The non-EU dedicated standards are expected to follow later in 2023. It may be tempting to wait for the non-EU dedicated standards; however, given the breadth of the potential disclosures, we advise companies not to delay but instead to begin their assessments now by referencing the proposed ESRS.

When would companies need to start reporting under the CSRD?

Like the question of *which* standards to apply, determining *when* companies would need to adopt is expected to vary based on a company's facts and circumstances. All "large undertakings," as defined above, that have more than 500 employees and securities listed on an EU-regulated market (i.e., "issuers") would be among the first companies required to report using ESRS. The first wave of reporting would be required beginning in fiscal year 2024 (filed in 2025). All other "large undertakings" in scope of the CSRD would generally have another year, followed later by all other companies in scope.

Understanding whether a company may be required to report beginning in fiscal year 2024 is a critical first step for planning and may need the advice of legal counsel. Even companies that would not be required to report until fiscal year 2025 or later do not have much time to develop the necessary processes and controls. As such, leading practice would be to evaluate current disclosures and identify significant gaps based on the initial exposure drafts.

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 (ISSB) 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."

Thirteen exposure drafts were published for public consultation by EFRAG in April. These proposals cover a company's ESG strategy, targets and progress, products and services, business relationships, incentive programs, and value chain. The proposed disclosures in these standards are intended to assist stakeholders in assessing a company's focus on sustainability and are interlinked with the company's discussion of its business model and strategy to provide a picture of how the company fits into and contributes to society more broadly. Comments on the exposure drafts were due August 8, and final standards are expected by mid 2023. Sector standards are also in development, with public consultation expected later in 2022 or 2023.

The thematic areas included in the ESRS go well beyond the disclosures introduced in the SEC's March proposal to enhance and standardize climate-related disclosures. As a result, multinational companies should be prepared for incremental disclosure requirements under these standards. For example, one ESRS exposure draft on biodiversity and ecosystems includes a requirement to disclose whether a company is committed to "no net loss" and "net gain" targets related to biodiversity by 2030 and 2050, respectively, and if there is no commitment, explain why not. This is an example of disclosure potentially driving behavior as a company may decide to make a public biodiversity commitment rather than disclosing that it does not have one.

Companies will need to develop the appropriate processes and controls to accumulate the necessary data and support its reliability. This may be particularly challenging if reporting will be required for the first time at a sub-consolidation or subsidiary level.

How do EFRAG's proposed climate disclosure requirements differ from the SEC's proposed climate rules?

Like the SEC's proposed rules, the proposed climate disclosure requirements in the ESRS exposure draft are based on the pillars of the Task Force on Climate-Related Financial Disclosure (TCFD) framework, and so some elements mirror proposed SEC disclosures. The proposed ESRS disclosures, however, would be more robust than current required reporting worldwide and would go beyond other proposals, including the disclosures proposed by the SEC. For example, the SEC requires disclosure of greenhouse gas (GHG) emissions reduction targets *if* the company has made one. The ESRS, on the other hand, would require companies to *have* an emissions reduction target for specific years and to disclose overall progress towards the target, and whether the progress is in line with what was initially planned.

Other proposed disclosure requirements in the climate exposure draft 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 the short, medium, and long term
- The company's policies and action plans for climate change mitigation (i.e., 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)
- Performance measures, including scope 1, scope 2, and scope 3 GHG emissions, and GHG emissions per dollar of net revenue (GHG intensity)
- Reconciliations of amounts used to calculate metrics to amounts included in the financial statements

Even companies that currently prepare reports under the TCFD framework are likely to need to expand the nature and extent of their disclosure to comply with the proposed scope of the CSRD.

What information would a company be required to disclose about its value chain?

Value chain disclosures may be some of the most challenging areas of reporting, given the scope and the reliance on information from parties not controlled by the company. The proposed disclosure requirements include key features of the value chain in the context of sustainability. For example, value chain disclosures would include:

- How a company considers its value chain in the assessment of material sustainability risks
- Details about value-chain related greenhouse gases removed from the atmosphere
- A description of workers in the value chain
- Communities affected by the value chain
- How direct customers and those further down the chain use the company's products and services

If all of the necessary information is not available, companies can omit value chain disclosures for the first three years after implementation of the CSRD on a "comply or explain" basis, meaning that companies would need to explain the reason for omitting any disclosures. This delay is expected to provide companies with more time to develop a plan to gather the relevant information.

How would materiality be determined?

As mentioned above, the CSRD embraces “double materiality,” which requires that companies report information necessary to understand:

- 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 (an “inside-out” perspective); and
- how sustainability matters affect a company’s business development, performance, and position (an “outside-in” perspective).

According to language in the 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. This approach to materiality acknowledges the needs of stakeholders beyond investors and other capital providers. In contrast, the International Sustainability Standards Board and SEC have proposed disclosure standards that retain the focus on what is material to investors, consistent with how it is interpreted in current financial reporting.

Is any relief expected for companies reporting under another framework (e.g., the SEC’s requirements)?

Possibly. The draft legislation states that it may be possible to satisfy the CSRD reporting requirements using information submitted under another reporting regime if the European Commission determines that they are prepared “in a manner equivalent to” the ESRS. The European Commission has not made any determinations of equivalency, and it is unclear at this time how long that process will take. Further, given certain differences in scope and key concepts (such as materiality) among the three proposals, it remains to be seen whether those frameworks would be deemed equivalent. As such, at this time, companies expecting to be in scope would be well served to assume they will need to prepare the full disclosures required by the CSRD.

Would third-party assurance be required?

Yes. The CSRD would include a mandatory assurance obligation for reported sustainability information. While the SEC has proposed assurance only over greenhouse gas emissions for some types of registrants, the CSRD would require assurance over all of the company’s sustainability reporting.

The requirements would begin with limited assurance and expand to reasonable assurance at a later date. Limited assurance is a negative form of assurance stating that no matter has been identified by the auditor to conclude that the subject matter is materially misstated. Reasonable assurance will require more extensive procedures, including consideration of the company’s internal controls. 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 over the content.

The company’s financial statement auditor would be able to provide assurance, per the current provisional agreement, but Member States may allow a different auditor or an independent assurance service provider to provide assurance on sustainability reporting, as long as accreditation is obtained as directed in the CSRD, and the provider is subject to oversight and quality requirements equivalent to those in place for financial statement auditors.

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 an explanation of “how the audit committee contributed to the integrity of sustainability reporting and what the role of the audit committee was in that process.”

What's next?

Given the potentially complex scope assessment and wide-ranging disclosure requirements, as well as the expected effort to obtain information and develop and implement reporting systems, companies should start to prepare for any reporting obligations now. The first step is to determine whether the global organization or any part of it, is in scope. Next, companies should evaluate what compliance with the disclosure requirements entails, and the applicable effective dates. This includes consideration of other EU regulations that may apply to companies in scope of the CSRD (for example, the EU taxonomy on sustainable economic activities). These determinations may be thorny and a company should assess the need for early involvement of its legal team.

The CSRD is about more than just mandating sustainability disclosures; it is aimed at driving behavioral change. Companies have the opportunity to reframe the narrative of their purpose and business model in the context of sustainability. It will be a journey, but companies can position themselves for success through early engagement.

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For more PwC accounting and reporting content specific to ESG matters, visit our ESG/Sustainability Reporting page at *viewpoint.pwc.com*.

Appendix

Examples of common structure and size scenarios with related requirements

The following simplified fact patterns are provided to illustrate some of the factors that should be considered in evaluating the scope, applicable standards and timing of application. These examples do not consider the ability to prepare combined reports in limited instances, and to satisfy subsidiary reporting requirements by reporting at a higher level within the organization. The actual analysis is complex and companies should review the rules carefully and assess the need for early involvement of its legal team. Further, there may be exceptions to the effective dates in the examples below as a result of changes made to these directives by EU Member States.

<table>
<tr><th>Fact pattern</th><th>What reporting standards are applicable?</th><th>When is reporting mandatory for a calendar year-end company?</th></tr>
<tr><td>Non-EU parent company
parent company has debt or equity securities listed on an EU-regulated market
parent meets the definition of a “large undertaking” or is the parent of a “large group”
parent or “large group” has more than 500 employees</td><td>ESRS reporting on a global consolidated basis</td><td>January 1, 2024, reporting in 2025</td></tr>
<tr><td>Non-EU parent company
parent company has debt or equity securities listed on an EU-regulated market
parent meets the definition of a “large undertaking” or is the parent of a “large group”
parent or “large group” has between 250 and 500 employees</td><td>ESRS reporting on a global consolidated basis</td><td>January 1, 2025, reporting in 2026</td></tr>
<tr><td>Non-EU parent company
generated net turnover (revenue) of more than €150 million in the EU
parent has one (or more) of the following:
at least one EU subsidiary that meets the definition of a “large undertaking”
at least one EU subsidiary that has debt or equity securities listed on an EU-regulated market,
at least one branch with revenue of more than €40 million</td><td>Non-EU dedicated standard reporting at global consolidated level

May be in addition to the subsidiary reporting requirements</td><td>January 1, 2028, reporting in 2029</td></tr>
</table>

Fact pattern	***What reporting standards are applicable?***	***When is reporting mandatory for a calendar year-end company?***
EU subsidiary ● non-EU parent company ● subsidiary meets the definition of a “large undertaking” ● subsidiary has debt or equity securities listed on an EU-regulated market ● subsidiary has more than 500 employees	ESRS reporting at individual subsidiary level	January 1, 2024, reporting in 2025
EU subsidiary ● non-EU parent company ● subsidiary meets the definition of a “large undertaking” ● subsidiary has debt or equity securities listed on an EU-regulated market ● subsidiary has between 250 and 500 employees	ESRS reporting at individual subsidiary level	January 1, 2025, reporting in 2026
EU subsidiary ● non-EU parent company ● subsidiary meets the definition of a “large undertaking” or is the parent of a “large group” ● subsidiary does not have debt or equity securities listed on an EU-regulated market	ESRS reporting at individual subsidiary level (or EU subgroup consolidated level)	January 1, 2025, reporting in 2026
EU subsidiary ● non-EU parent company ● subsidiary is an SME (meets the definition of a small undertaking or medium-sized undertaking, as defined in EU regulation) ● subsidiary has debt or equity securities listed on an EU-regulated market	Simplified standards reporting at individual subsidiary level	January 1, 2026, reporting in 2027, unless the SME avails itself of the exemption from reporting until 2028
EU subsidiary ● non-EU parent company ● subsidiary is a small and non-complex credit institution or captive insurance undertaking (as defined in EU regulation)	Simplified standards reporting at individual subsidiary level	January 1, 2026, reporting in 2027