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CSRD: New rules on corporate sustainability reporting

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Dec 2022

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01. A new era of sustainability reporting

Following the EU Commission's proposal[1] in April 2021, the EU Parliament and Council adopted standardised rules for disclosure of sustainability information in November 2022: the Corporate Sustainability Reporting Directive (CSRD)[2]. The reported data is supposed to bolster sustainable business practices and therefore promote corporate social responsibility and help make the EU carbon neutral by 2050, as targeted in the European Green Deal and in line with the Paris Agreement objective.

Disclosed information includes the impact companies have on people and the environment as well as the sustainability risk they face. To ensure comparability and transparency, not only qualitative statements but also detailed quantitative metrics must be reported in accordance with EU-wide standards. Furthermore, an external audit of the sustainability report (initially with limited assurance) is required as an integral part of the management report. The reporting standards will be harmonised with the information needs of financial market participants to ensure compliance with the requirements of the Sustainable Finance Disclosure Regulation (SFDR)[3]. The outcome has far-reaching consequences on corporate reporting by amending the Accounting Directive, Transparency Directive, Statutory Audit Directive and Regulation[4].

Companies subject to reporting obligations of the CSRD have to comply with Article 8 of the EU Taxonomy Regulation.

With its amendments to the Accounting Directive, the CSRD will expand the scope of affected entities from roughly 10,000 to more than 50,000 companies EU-wide. Besides listed companies with more than 500 employees, which already fall under the requirements originally introduced by the Non-Financial Reporting Directive (NFRD)[5], all large undertakings as well as insurance undertakings and credit institutions (both irrespective of their legal form) are now subject to the CSRD. Furthermore, listed small and medium-sized enterprises will be required to comply with the new sustainability reporting. Along with the CSRD reporting obligation, all affected companies must comply with the disclosure requirements formulated by the EU Taxonomy Regulation[6], the classification framework on environmentally sustainable economic activities.

Companies subject to the NFRD will be the first to fulfil the new sustainability reporting requirements for the financial year starting in 2024. Many of the newly affected companies will need to begin capturing the required data already in 2025 – a very demanding timeframe for collection, interpretation and disclosure of the required information.

In addition to new interdivisional data requirements, the focus of the CSRD is set on internal control and risk management systems, governance policies as well as the extensions of the audit committee's tasks in relation to sustainability reporting including the digital reporting process in accordance with ESEF[7] and EU Taxonomy requirements. With respect to due diligence processes and principal (actual or potential) adverse impacts regarding sustainability matters, the CSRD stipulates the consideration of other EU requirements on undertakings to conduct a due diligence process and thus already refers to the proposal of the Corporate Sustainability Due Diligence Directive (CSDDD)[8]. Overall, this makes the implementation of the CSRD a challenging task for smaller and larger undertakings alike.

1 COM(2021) 189 final
2 Directive (EU) 2022/2464
3 Regulation (EU) 2019/2088
4 Directives 2013/34/EU, 2004/109/EC and 2006/43/EC, and Regulation (EU) No 537/2014
5 Directive 2014/95/EU
6 Regulation (EU) 2020/852
7 XHTML format referred to in Article 3 of Commission Delegated Regulation (EU) 2019/815 and Inline XBRL markups
8 COM(2022) 71 final

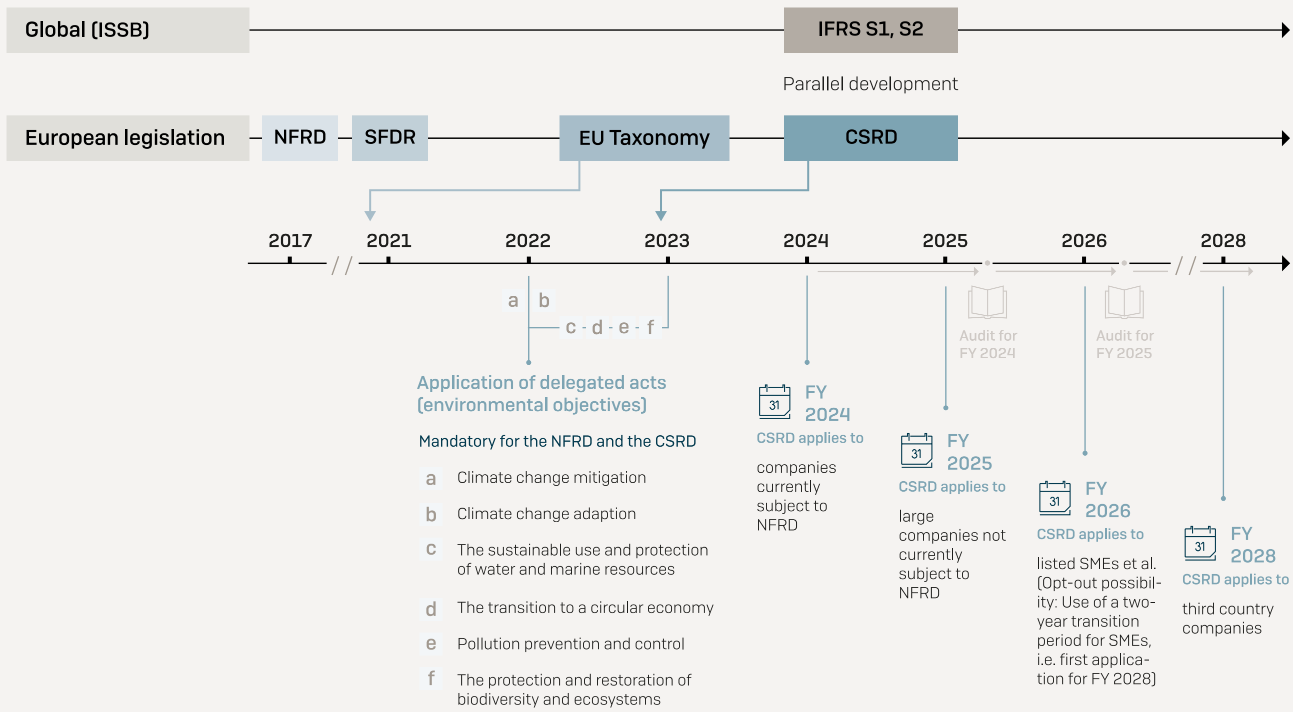

Figure 1: Timeline on the development and application of sustainability reporting standards with focus on CSRD.

In order to facilitate uniform disclosures, EFRAG has been mandated to develop a comprehensive set of European Sustainability Reporting Standards (ESRS). The creation of uniform reporting requirements is aimed at minimising the diversity of existing sustainability reporting frameworks, some of which are listed below:

- Global Reporting Initiative (GRI)
- Task Force on Climate-Related Financial Disclosures (TCFD)
- Sustainability Accounting Standards Board (SASB)
- German Sustainability Code (DNK)

While some companies might not yet apply any such framework, other companies need to differentiate between what they already disclose (voluntarily or as part of the NFRD) and what is part of the significantly more extensive CSRD.

Global standard-setting initiatives are being developed in parallel.

Making the situation even more complex, on a global scale the International Sustainability Standards Board (ISSB) is endeavouring to establish a global baseline in sustainability reporting. Though the CSRD emphasises the necessity to consider initiatives of global standard-setters, it is currently unclear to what extent the final ESRS will have features in common with the corresponding ISSB standards (IFRS S1 and S2).

Clear, consistent and decision-useful sustainability reporting is becoming even more complex and therefore is difficult to achieve. To implement the extensive CSRD requirements successfully, companies need a structured implementation approach based on sound and consistent data and efficient business processes.

02. Comprehensive disclosure requirements

2.1 Towards uniform reporting standards

The CSRD is part of the EU's strategy to strengthen the market of sustainable investments. As of today, there is still little comparable sustainability data available. Information gaps stem from the small number of companies currently reporting as well as the lack of reporting comparability due to existence of heterogeneous standards.

As a building block for a thorough sustainability assessment, the CSRD requires, among other aspects, the introduction of a comprehensive double materiality principle. In this approach, undertakings must analyse both their impact on people and the environment (impact materiality) and the financial impact of sustainability matters on their business (financial materiality). If a sustainability issue is considered material in either sense, it must be included in the company's sustainability statements.

About half of the individual disclosure requirements are of a quantitative manner.

Comparable sustainability assessment is enforced by the introduction of a uniform set of standards, which additionally achieves the build-up of a standardised and extensive source of ESG data. The latest ESRS Exposure Drafts[9] developed by EFRAG include two cross-cutting standards that define general reporting principles and ten sector-agnostic standards; all of which are mandatory for all undertakings subject to an obligation to publish a sustainability report pursuant to the CSRD.

These standards will be complemented by additional sector-specific disclosure requirements, which, as of now, are still in an early stage of development. Given the scope and complexity of this endeavour, which covers more than 40 sectors in total, EFRAG decided to deliver three consecutive annual sets of standards. Reflecting the tight schedule – the first set needs to be delivered in November 2023. In order to allow the Commission to adopt the binding standards by June 2024 – only ten top impact sectors will be addressed. Five of these benefit from previous and ongoing work of the GRI. By November 2024, the remaining CSRD priority sectors will be addressed by EFRAG. One year later, the ESRS will be completed with the fourth set of standards. Technical expert groups are currently discussing the first set; a public consultation is expected in March 2023.

To implement the CSRD, companies first need to ascertain their potential reporting obligations. This includes mapping their business activities – categorised according to the Nomenclature of Economic Activities (NACE)[10] – to those associated with each given sector-specific standard.

In order to deal with the continuous development of the standards and to meet the regulatory timeframe, a project approach needs to be developed and successively adapted to meet the requirements and complexity of companies' businesses. Particular consideration should be given to the technical implementation timeline.

9 EFRAG submitted the first set of final ESRS drafts to the European Commission on November 23, 2022 as part of its advisory mandate.

10 Regulation (EC) No 1893/2006

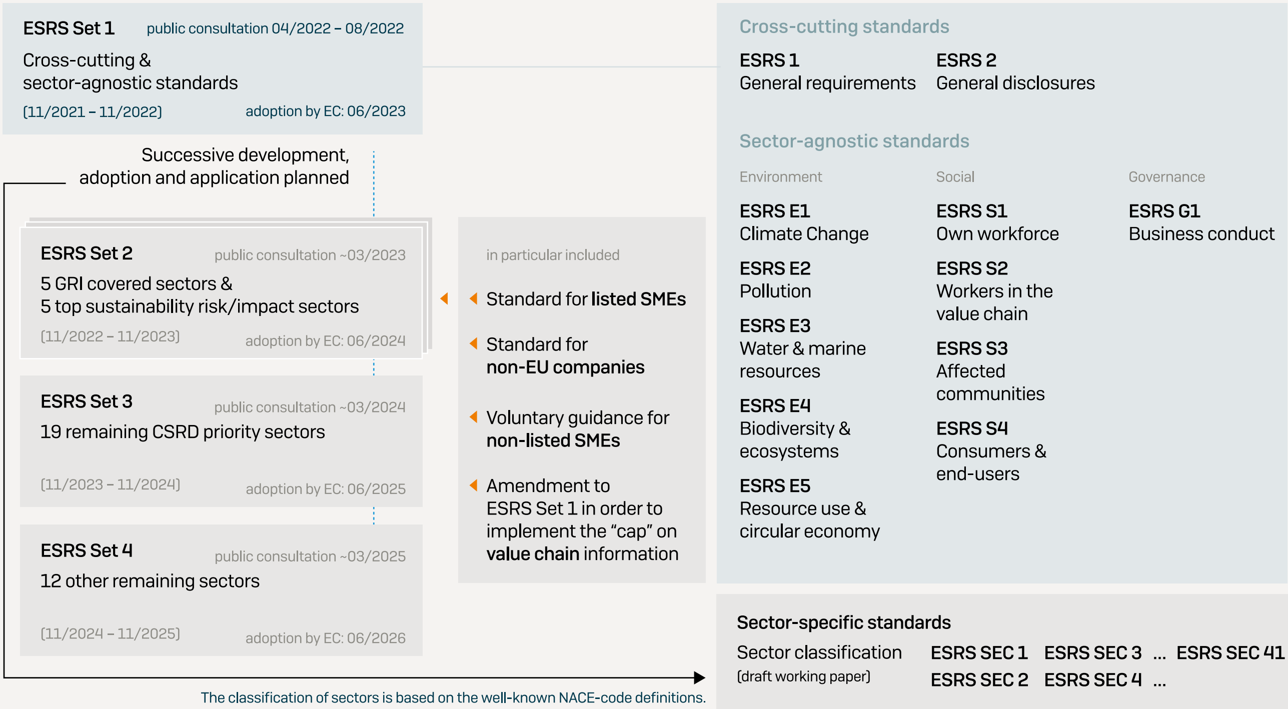

Figure 2: Overview over the European Sustainability Reporting Standards according to the CSRD.

2.2 Three pillars of sustainability information

According to the CSRD, reporting shall cover the three thematic areas of *Environment, Social* and *Governance*.

Environmental standards correspond to the environmental objectives of the EU Taxonomy: climate change mitigation and adaptation, pollution prevention and control, sustainable use and protection of water and marine resources, transition to a circular economy and protection and restoration of biodiversity and ecosystems. For these standards, companies must, in addition to the standard's own requirements, disclose information on turnover, capital expenditure and operating expenditure according to the EU Taxonomy.

Social standards focus on demands of individuals along the value chain. Undertakings are required to report on working conditions and equal opportunities for their own workforce as well as engagement with value chain workers, affected communities and consumers.

Governance aspects are addressed in the cross-cutting standard on general disclosures and cover the role and work of the internal bodies as well as sustainability due diligence and reporting processes. This information is supplemented by a separate standard on business conduct.

2.3 Requirement complexity

In accordance with the TCFD recommendations, each disclosure requirement is categorised into one of the four following reporting areas: (i) governance, (ii) strategy, (iii) impact, risk, and opportunity management and (iv) metrics and targets. Drivers of complexity for these requirements are rooted in scope, methodology and the general availability of information.

Quantitative requirements like the breakdown of Scope 3 greenhouse gas emissions (in particular according to upstream purchased and downstream sold products, goods transportation, travels and financial investments) are generally considered highly challenging. While In addition, qualitative requirements can be less demanding than quantitative ones, this is not necessarily the case. Documentation of most qualitative disclosures, such as the volume of policies to be described and the consistent presentation of information (e.g. in the management report and on the website), is generally time-consuming, even if some of these measures are already in place. For example, a single disclosure requirement asks for a comprehensive description of roles and responsibilities of company's bodies and management levels with regards to sustainability matters.

In particular, drivers of complexity clearly lie in the reporting of metrics and targets as well as in the disclosure of forward-looking information. Since the methodology for calculation of required indicators has not yet been finalised and will most probably leave freedom of interpretation, the implementation of the CSRD will pose a significant challenge. This applies equally to companies already subject to the NFRD and those newly included in the Directive's scope of application.

03. Challenges in implementation

With the large number of disclosure requirements and the introduction of new mandatory concepts, the CSRD poses multi-faceted challenges to companies. To address these challenges appropriately, companies must check each disclosure requirement individually and carefully.

Implementation of disclosure requirements forces companies to assess whether a sustainability issue is considered material and whether a disclosure is necessary. This is the case for every CSRD requirement as well as issues that are not addressed under mandatory disclosure and require entity-specific disclosure. If an issue is material, companies need to evaluate which data is required for disclosure. Some of this data might not be readily available, as companies might not yet meet the legal requirements of the CSRD, such as alignment with the objective of limiting global warming to 1.5°C. Others might stem from a product's value chain and are not readily accessible to financial and non-financial companies alike, potentially depending on their position in the value chain. Basic definitions of terms and methods are often missing and require companies to develop their own solutions. Factors such as highly integrated production sites, complex product catalogues and global supply chains further complicate this process.

Given the scope and complexity of the new sustainability reporting framework, an early assessment of the company-related impact is crucial to meet the demanding implementation timeline. Regulatory refinement of specific requirements calls for a proficient expert to assist you in this challenging endeavour.

Implementation on reporting entity level poses further challenges for companies dealing with the CSRD. For access to necessary information from all business units, respective experts and subsidiaries, a clear governance structure must be introduced. To enable this cross-team collaboration, companies should also install suitable IT structures that are able to systematically capture, collect and organise sustainability data. Individual units within companies often still lack the necessary instruments to provide required data in an efficient and audit-compliant manner. A correct IT infrastructure is the key to achieving a single-point-of-truth for all sustainability data and facilitating internal and external consistency in reporting. All of these changes to how companies operate and manage sustainability should be well thought out and avoid hurried implementations.

Companies should address the variety of imposed challenges as early as possible. Besides, more extensive sustainability information offers opportunities in terms of tailored funding. Conducting materiality and gap analyses is a possible step towards the operationalisation of a company's sustainability reporting. Closing the identified gaps, introduction of governance and IT structures as well as further engagement with internal and external stakeholders could follow. The deadlines set by the EU call for early action in any case.

d-fine supports you in preparing for the CSRD. We have long-standing experience in reporting of financial and non-financial information, implementing tailor-made IT and data infrastructures as well as in quantifying the sustainability of companies, processes and products. We make value chains transparent and develop strategies for your sustainable and digital transformation.

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