
# EU Corporate Sustainability Reporting Directive

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## Key Takeaways

- The CSRD will supersede the NFRD and require large corporations, public SMEs, and certain foreign businesses operating in the EU to report on sustainability considerations beginning in 2024
- The CSRD reporting standards are in development with the assistance of EFRAG; the standards will align to the Taxonomy Regulation and reflect a principal of 'double materiality'
- The CSRD will require reported information to undergo third-party assurance
- The CSRD may serve as a future data source for PAI reporting requirements under the SFDR

## Overview

On November 28th, 2022, the European Council adopted the Corporate Sustainability Reporting Directive (CSRD) to require certain EU entities to report on sustainability considerations relevant to their operations; the CSRD will apply to large businesses, public small and medium-sized enterprises (SMEs), and foreign businesses with substantial operations in the EU. EU member nations are expected to transpose the CSRD's requirements into national laws over the following 18 months, and the rules will begin applying to different EU businesses, depending on specific criteria, between 2024 and 2028.

The CSRD will replace and expand the applicability of the Non-Financial Reporting Directive (NFRD), which requires large, public-interest EU companies to disclose non-financial and diversity information. In contrast, the CSRD applies to all large EU businesses, listed SMEs, and non-EU companies with substantial EU activity under the CSRD. As such, the CSRD will introduce a mandatory sustainability reporting framework for many more EU businesses; it is expected to apply to approximately 50,000 entities compared to 12,000 under the NFRD. The CSRD will also expand the scope of reporting requirements, requiring companies to disclose their sustainability risks and impacts on society and the environment separately (a principal called 'double materiality'), provide forward looking qualitative and quantitative information, and report in line with the EU Taxonomy Regulation and Sustainable Finance Disclosure Regulation (SFDR).

The CSRD was originally proposed to support the EU Green Deal, a set of economic and environmental policy measures to ensure the EU achieves its Paris Agreement greenhouse gas (GHG) emission targets. By mandating the public disclosure of sustainability information, including businesses' climate change impacts, the CSRD adds regulatory and public pressures for these businesses to meet the lofty climate goals set by the EU Green Deal. The CSRD will also require reported information to undergo independent auditing and assurance. Furthermore, the CSRD also provides a standard format of reporting requirements for nearly 50,000 EU businesses that can be easily compared across industries. The CSRD will thus promote greater accountability for EU businesses, encourage investment towards more sustainable economic activities, and reduce instances of corporate greenwashing.

The role of developing this framework is assigned by the European Commission to the European Financial Reporting Advisory Group (EFRAG). The EFRAG is still developing the CSRD reporting standards and is expected to assist the Commission in adopting a first set of standards by June 2023.

### Reporting Schedule

The directive would require all relevant businesses in the EU to begin reporting on sustainability considerations at different dates. Disclosure requirements would be phased in over the next decade—with companies already subject to the NFRD required to begin recording reporting requirements in 2024, large companies in 2025, publicly listed SMEs in 2026, and foreign businesses in 2028. The following table summarizes the schedule of CSRD reporting dates for applicable entities with different operating characteristics.

| Company Type | Company Characteristics | Effective Date | First Year of Reporting |
| --- | --- | --- | --- |
| **Companies subject to the NFRD** | (1) Public-interest entities (i.e., publicly listed companies, credit institutions, insurance undertakings) established within the EU<br>(2) Headcount of 500 or more employees | January 1, 2024 | 2025 |
| **Large EU Companies** | Two of the three following conditions:<br>(1) Headcount of 250 or more employees<br>(2) Net turnover of €40M or greater<br>(3) Total balance sheet assets of €20M or greater | January 1, 2025 | 2026 |
| **Public EU SMEs** | Publicly listed companies that meet the following conditions:<br>(1) Headcount of 10 or more employees<br>(2) Net turnover of €2M or greater, or total balance sheet assets of €2M or greater | January 1, 2026* | 2027 |
| **Foreign Businesses with EU Operations** | Non-European companies with EU operations that meet the following conditions:<br>(1) Branch(es) with net turnover of €150M or greater (consolidated)<br>(2) Subsidiary(ies) that are large companies or listed SMEs | January 1, 2028 | 2029 |

*SMEs have an option to opt out of requirements until 2028 (first year of reporting in 2029)

### Key Reporting Requirements

Notably, the CSRD standards are not yet finalized, with the European Commission expected to adopt an initial set of standards by June 2023. However, reporting requirements will require companies to not only disclose how sustainability may affect the financial positions of their businesses, but also how their activities impact communities and the environment—a concept known as 'double materiality'. The reporting standards will take a forward-looking qualitative and quantitative approach by mandating that firms disclose environmental, social, and governance (ESG) information—including sustainability risks, impacts on society, material topics for stakeholders, and targets and progress towards goals. The CSRD will specifically define five areas of reporting, including 1) companies' business models, 2) policies, 3) policy outcomes, 4) risks and risk management, and 5) key performance indicators relevant to the businesses.

Most recently, EFRAG submitted a first draft of European Sustainability Reporting Standards (ESRS) to the European Commission on November 23rd, 2022. The CSRD ESRS is closely aligned with the environmental objectives of the EU Taxonomy Regulation, and establishes environmental reporting standards around climate change, pollution, water and marine resources, biodiversity and ecosystems, and resources and circular economy. Social standards include equal employment opportunity, safe working conditions, human rights, and fundamental freedoms for companies' workforces, their value chain workers, the communities they affect, and their customers and end-users. Governance standards also include business ethics, anti-bribery and corruption, political engagements, and other internal controls and risk management systems around business conduct. Under the CSRD, companies will also need to report on how their business model and strategies are compatible with the Paris Agreement's goal of limiting of global warming to 1.5°C.

Furthermore, the CSRD will introduce a mandatory audit and assurance regime. This mandated third-party assurance of reported information differentiates the CSRD from the NFRD and is required to ensure the reliability of data and avoid greenwashing. Assurance will require integration of sustainability considerations into the auditor's report, including a description of the involvement of the auditing partner and the process utilized to identify relevant information. Reported information must be submitted in a management report and a digitally tagged, electronic format (i.e., XHTML) to facilitate aggregation and comparison of data across reporting companies and industries.

### Impacts on Private Markets

The CSRD also supports the Sustainable Finance Disclosure Regulation (SFDR), which created ESG disclosure obligations for many financial market participants that go into effect in 2023. These obligations include the requirement for General Partners (GPs) and their Limited Partners (LPs) to report on the Principal Adverse Impacts (PAIs) of their investment decisions on environmental and social factors. As such, GPs will increasingly face requests for fund PAI data from their LPs, who are often obliged to collect and aggregate the information. However, many GPs do not yet have a formal process in place to gather relevant ESG data required to report on PAIs. Furthermore, without appropriate guidance on data collection practices or easily available data, GPs may use different approaches to source data, making it difficult to compare and utilize disclosed information.

The CSRD directive can help address these challenges, as it would create standardized ESG reporting obligations for many large EU portfolio companies of private equity investors. Therefore, the CSRD may serve as a potential future data source for investor PAI reporting requirements under the SFDR as it not only significantly increases the number of companies in scope compared to the NFRD, but it also introduces singular reporting standards to be developed by EFRAG. However, it is important to note that the timelines of the SFDR and CSRD are not aligned; ESG reporting for the CSRD is not required until 2025 for fiscal year 2024 for most companies, while SFDR reporting obligations are already in place.

In the meantime, large companies to which the CSRD would apply—including existing and future portfolio companies of private equity investors—will need to engage independent audit partners in order to comply with CSRD requirements starting in 2024. These businesses can prepare for incoming requirements by beginning to consider the materiality of sustainability to their operations—if they are not already doing so. Private equity investors can also support their current and future European portfolio companies in considering their material ESG risks and impacts, which can include identifying an ESG strategy and future scenarios, main risks and impacts, targets, progress, and KPIs, supply chain, the role of management, and mechanisms through which reportable information will be identified. Malk is well-positioned to assist GPs in describing their ESG strategies and will continue to carefully track developments in the proposed rule to ensure that its due diligence, strategy, and investor relations materials align clients with the most current CSRD requirements.

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