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Commentary

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# What the CSRD Could Mean for Companies in the EU

***A series of early-stage working papers provide insight into how a proposed EU legislation might expand companies' ESG reporting obligations.***

On 21 April 2021, the European Commission adopted the Corporate Sustainability Reporting Directive (CSRD)[1], a legislative proposal to strengthen the nature and extent of sustainability/ESG reporting in the European Union. The CSRD's adoption marked a significant development in the ESG reporting landscape, and the proposed changes would constitute substantial regulatory reform in the ESG reporting space.

The specific reporting requirements of the CSRD are underpinned by the reporting standards that have been under development for the last year. While not final, draft working papers (Working Papers) have been made publicly available on a rolling basis since early 2022, providing companies with helpful guidance on what to expect and offering an initial understanding of the significant impact that the CSRD requirements will have on businesses.

This Client Alert discusses the key issues in some of the Working Papers and how the proposed CSRD requirements could impact companies.

## Background

The reforms proposed by the CSRD are based on a number of factors, but one of the main reasons was a concern among many investors and the EU that ESG reporting under the Non-Financial Reporting Directive (NFRD)[2] was not adequate. The quality (i.e., completeness, reliability, and comparability) of ESG reporting was viewed as falling short of the standard required to lead to a shift in capital to ESG-aligned investments. The CSRD proposals, therefore, considerably enhance the scope of the NFRD and cover a wide range of ESG elements with the overall aim of redirecting capital accordingly. The CSRD further aims to align with other EU initiatives on sustainable finance, in particular the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation (the other key elements of the EU's Sustainable Finance Action Plan), as well as to incorporate essential elements of globally accepted standards and key international ESG reporting initiatives that are being developed.

The proposed CSRD is likely to undergo additional changes as it moves through the legislative process. In its current form, some key differences compared to the NFRD include that the proposed CSRD:

- Extends the scope to all large companies[3] (including private companies) and all companies listed on regulated markets (except listed micro-enterprises);

- Requires the audit (assurance) of reported information[4];
- Introduces more detailed and standardised reporting requirements, with a requirement to report according to mandatory EU ESG/sustainability reporting standards (ESRS) and EU ESG/sustainability reporting guidelines (ESRG); and
- Requires companies to digitally "tag" the report, with tagged information to be published in a dedicated section of company management reports (i.e., reports to be provided electronically/digitally in XHTML format in accordance with European Single Electronic Format regulation).

The Legal Affairs Committee of the European Parliament adopted its position on the CSRD on 15 March 2022, and talks with representatives of Member States at the European Council to negotiate a final legislative text will start once the Parliament as a whole approves its negotiating position. The final timetable will depend on how the Parliament and Council progress in those negotiations. If an agreement is reached in the first half of 2022, then the European Commission may be able to adopt the first set of reporting standards under new legislation by the end of 2022, and companies would have to apply the standards for the first time in reports published in 2024, covering their 2023 financial year.

The European Commission mandated the European Financial Reporting Advisory Group (EFRAG) to develop the draft ESRS requirements. In parallel to a governance reform at EFRAG, which amongst other things has established a Sustainability Reporting Board, a task force was set up to work on the development of the ESRS — the Project Task Force on European Sustainability Reporting Standards (PTF-ESRS). The PTF-ESRS comprises members from 13 Member States, with a number of categories of stakeholders including auditors/assurance providers, financial institutions, non-financial corporations, NGOs/trade unions, and SMEs. The PTF-ESRS is also complemented by representatives from European public authorities and supported by a robust secretariat and dedicated expert working groups — all working collectively in developing the standards.

## Publicly Available Working Papers and Architecture of the ESRS

Working Papers have been made publicly available on the EFRAG website for transparency purposes and in accordance with the agreed process for the development of the ESRS. These early-stage Working Papers are available as preparatory work-in-progress documents, to provide stakeholders with an initial understanding of the conceptual thinking behind the draft standards and the direction being taken in terms of disclosure requirements. Notably, these Working Papers are not open to public consultation, and before that process commences they will go through extensive subsequent reviews, which may give rise to significant changes, including review by:

- All PTF-ESRS members, including consensus-building questionnaires;
- The PTF-ESRS review panel and relevant co-construction partners; and
- Dedicated expert working groups to provide input.

As such, these Working Papers **do not reflect the view of the PTF-ESRS as a whole at this stage, or the position of relevant co-construction partners, the European Union, or the European Commission**. Notably, additional changes may be made once the work of the PTF-ESRS is handed over to the EFRAG governing bodies. EFRAG provided an update on 30 March 2022 that the target is to complete the first set of exposure drafts and launch the public consultation of the exposure drafts by the end of April 2022, which also concludes the work of the PTF-ESRS.

The Working Papers made publicly available as of the date of this Client Alert are detailed in Figure 1 below, which also reflects the ESRS reporting architecture. The various components of the overall architecture as it is currently envisioned include the following:

- **Cross-cutting standards (CCS):** The CCS are intended to address disclosures on general, non-topical matters. They address general ESG reporting provisions, including those relevant to due diligence and specific content in relation to ESG matters, and provide references for the topical standards.
- **Sector-agnostic standards:** These are standards for each of the E, S, and G of ESG.
- **Sector-specific standards:** ESRS SEC1 is a classification standard providing guidance for the undertaking to identify the sector(s) it operates in and the related sector-specific disclosure requirements. There are 14 sector groups and 40 sectors.
- **Presentation:** This component provides the basis for presentation of ESG reporting within the management report (as prescribed by the CSRD).
- **Conceptual guidelines:** These guidelines are used as tools for the standard setter to facilitate the incorporation of concepts into the standards (i.e., relevant background research).

### Figure 1: ESRS reporting architecture

| CCS | Sector-Agnostic Standards | | | Sector-Specific Standards | | Presentation |
|---|---|---|---|---|---|---|
| **Strategy, governance, impacts, risks, and opportunities** | **Environmental** | **Social** | **Governance** | **Classification** | **ESG sector-specific disclosures** | |
| **ESRS 1**<br>General provisions | **ESRS E1**<br>Climate change | **ESRS S1**<br>Own workforce – general | **ESRS G1**<br>Governance, risk management internal control | **ESRS SEC 1**<br>Sector classification | | **ESRS P1**<br>Sustainability statements |
| **ESRS 2**<br>Strategy and business model | **ESRS E2**<br>Pollution | **ESRS S2**<br>Own workforce – working conditions | **ESRS G2**<br>Products and services, management and quality of relationships with business partners | | | |
| **ESRS 3**<br>Sustainability, governance, and organization | **ESRS E3**<br>Water and marine resources | **ESRS S3**<br>Own workforce – equal opportunities | **ESRS G3**<br>Business conduct | | | |

| CCS | Sector-Agnostic Standards | | | Sector-Specific Standards | | Presentation |
|---|---|---|---|---|---|---|
| **Strategy, governance, impacts, risks, and opportunities** | **Environmental** | **Social** | **Governance** | **Classification** | **ESG sector-specific disclosures** | |
| **ESRS 4**<br>Sustainability, material impacts, risks, and opportunities | **ESRS E4**<br>Biodiversity and ecosystems | **ESRS S4**<br>Own workforce – other work-related rights | | | | |
| **ESRS 5**<br>Definitions for policies, targets, action plans, and resources | **ESRS E5**<br>Circular economy | **ESRS S5**<br>Workers in the value chain | | | | |
| | | **ESRS S6**<br>Affected communities | | | | |
| | | **ESRS S7**<br>Consumers / end-users | | | | |

| Conceptual Guidelines | | | | | |
|---|---|---|---|---|---|
| **ESRSG 1**<br>Double materiality | **ESRSG 2**<br>Characteristics of information quality | **ESRS G3**<br>Time horizons | **ESRS G4**<br>Boundaries and levels of reporting | **ESRS G5**<br>EU and international alignment | **ESRS G6**<br>Connectivity |

## Analysis of Working Papers

As noted above, the content of the Working Papers could change considerably over the course of the extensive internal and public consultation processes that are still pending. The amendments that have already been flagged as having taken place with respect to ESRS 1 (see below) are a good example.

However, as the first public documents that reveal insight into the possible future content of the requirements under the CSRD and their advisers, the Working Papers are a useful guide for companies that may be subject to the CSRD as to what the specifics of the obligations under the CSRD may entail.

For this reason, this Client Alert discusses below some of the key specific issues identified in the Working Papers, and how they could impact companies that would be required to report pursuant to the CSRD. Given the large number of Working Papers, this Client Alert focuses on a selection of three that may be considered especially notable and provide a mix of sector-agnostic/topical standards and CCS. These are: (i) ESRS 1 (*General Provisions*); (ii) ESRS E1 (*Climate Change*); and (iii) ESRS S5 (*Workers in the Value Chain*).

## Key Features of Specific Working Papers

### ESRS 1 (*General Provisions*)

The ESRS 1 (*General Provisions*) Working Paper (ESRS 1) prescribes the mandatory concepts and principles to apply for the preparation of ESG reporting under the CSRD, and contains general disclosure requirements that complement those required under the other ESRS.

Notably, when publishing ESRS 1 on 18 March 2022, the PTF-ESRS simultaneously issued a cover note, which described how, during the drafting of ESRS 1, the PTF-ESRS concluded that certain disclosure requirements that were initially released in different ESRS and ESRG should instead be consolidated into ESRS 1, including the entirety of ESRS 5 (*Definitions*), the earlier draft of which has now been entirely superseded. As a result, ESRS 1 forms the core basis of the overarching disclosure requirements as they have currently been presented.

ESRS 1 comprises a combination of general principles and general disclosure requirements that companies would be subject to under the ESRS.

The general principles cover:

- Approach to reporting under the ESRS;
- How to apply CSRD concepts;
- Disclosing on due diligence under the EU legal framework;
- Disclosing on policies, targets, actions and actions plans, and resources;
- Preparing and presenting ESG information; and
- How ESG reporting is linked to other parts of corporate reporting.

Notable aspects of the general principles include the focus that ESRS 1 places on the comparability and verifiability of information that is disclosed, as well as discussion of the core concept of double materiality. Double materiality is defined in ESRG 1 (*Double materiality*) as the “union” of impact materiality and financial materiality. An ESG topic therefore meets the criteria of double materiality from a corporate reporting standpoint if it is material from the impact perspective (i.e., the impact that the reporting company may have on society or other stakeholders), the financial perspective (i.e., impacting the short-, medium-, or long-term finances of the reporting company), or both. The use of double materiality as an element of the CSRD is a key difference between the EU’s proposed ESG reporting requirements and other similar proposed standards that primarily focus on financial materiality (for example, the exposure drafts of the proposed standards of the International Sustainability Standards Board (ISSB)).

In addition, in the context of due diligence, reference is made to diligence reporting requirements under the CSRD (specifically ESRS 3) and the OECD Guidelines for Multinational Enterprises, but no mention is made of the recently proposed EU Corporate Sustainability Due Diligence Directive (CSDDD). Three specific due diligence disclosure principles are identified, in relation to disclosing about (i) policies adopted to manage material sustainability matters; (ii) targets, progress, and tracking effectiveness; and (iii) actions, action plans, and resources in relation to policies and targets.

The 12 general disclosure requirements identified under ESRS 1 cover the following topics:

- General characteristics (e.g., information about the discloser and its general approach to its disclosures);
- Overview of strategy and business model;
- Sector(s) of activity;
- Key features of the value chain;
- Key drivers of value creation;
- General statement of compliance;
- Boundaries and value chain;
- Statement on due diligence;
- Estimation uncertainty;
- Changes in preparation and presentation;
- Errors; and
- Other ESG reporting frameworks.

Many of the disclosure requirements follow specific general principles that are identified in ESRS 1 (e.g., the disclosure statement on due diligence should follow and incorporate the disclosure principles on due diligence). Notably, disclosures of key features of the value chain shall include a description of key participants both upstream and downstream on the disclosing entity, but also the key resources the discloser is leveraging to perform its activities and the characteristics of its relationship with the end-users of products and services delivered by the value chain. In common with the other Working Papers, application guidance is also provided in relation to the disclosure requirements.

### ESRS E1 (*Climate Change*)

The ESRS E1 (*Climate Change*) Working Paper (ESRS E1) was published in January 2022 as part of the first full batch of Working Papers to be published, and was the only topical standard published at that juncture. ESRS E1 followed the prototype climate standard published in September 2021 with minor updates. Both the prior release of a prototype and the prioritised release of ESRS E1 in the first batch of Working Papers demonstrate the importance that the PTF-ESRS (and other stakeholders) placed on companies' climate-related disclosures.

ESRS E1 seeks to improve the quality and consistency of disclosures in relation to both climate change mitigation and climate change adaptation, and contains 23 disclosure requirements (four of which are optional) plus an additional Taxonomy disclosure requirement, and application guidance for each of the disclosure requirements.

The titles of each of the disclosure requirements is as follows:

- Transition plan in line with the Paris Agreement[5];
- Resilience of the strategy and business model to potential climate-related transition and physical risks;
- Climate-related targets and performance indicators in relation to compensation schemes;
- Internal carbon pricing schemes;
- Energy consumption and mix;
- Energy intensity;
- Scope 1 GHG emissions;
- Scope 2 GHG emissions;
- Scope 3 GHG emissions;
- Total GHG emissions;
- GHG removals (optional);
- Financing GHG mitigation projects outside the value chain (optional);

- Processes to identify material climate-related impacts, risks, and opportunities;
- Material climate-related impacts, risks, and opportunities;
- Policies implemented to manage climate change mitigation and adaptation;
- Measurable targets for climate change mitigation and adaptation;
- Climate change mitigation and adaptation action plans;
- Resources allocated to climate change mitigation and adaptation action plans;
- Avoided GHG emissions from products and services (optional);
- GHG intensity;
- Taxonomy Regulation for climate change mitigation and climate change adaptation (Taxonomy disclosure requirement);
- Financial exposure to physical risks;
- Financial exposure to transition risks; and
- Financial opportunities related to climate change mitigation or adaptation other than the Taxonomy Regulation (optional).

ESRS E1 also contains a detailed "basis for conclusions" section that discusses the rationale behind each of the disclosure requirements. Noteworthy aspects of the requirements and guidance on ESRS E1 include the fact that, whilst no specific calculation standard is identified for the reporting of Scopes 1–3 GHG emissions, disclosing entities are required to "consider" the principles of the GHG Protocol and the Global Reporting Initiative (GRI). Notably, much of the terminology in ESRS E1 is consistent with that used in the GHG Protocol. In addition, any purchased, sold, or transferred GHG emission offsets or allowances must be excluded from the reporting on gross Scope 1 GHG emissions.

Also notable is that transition plans mandated under disclosure requirement 1 (*Transition plan in line with Paris Agreement*) are required to be aligned with limiting global temperature increases to 1.5°C, a more aggressive target than that strictly mandated under the Paris Agreement. Entities that do not have specific climate change mitigation or adaptation targets are also required to disclose if and when such targets are to be adopted, the reasons why no targets have yet been adopted, and how they measure their progress toward climate change mitigation and adaptation without such targets.

The "basis for conclusions" section contains a discussion of other global reporting frameworks, including the ISSB prototype climate standard, the Task Force on Climate-related Financial Disclosures (TCFD), the Sustainability Accounting Standards Board (SASB) and the GRI Universal Standards, although no formal comparison between those standards and ESRS E1 is undertaken. Given the date of publication of ESRS E1, no mention is made of the subsequent climate disclosure rule proposed by the US Securities and Exchange Commission (SEC) on 21 March 2022, or the exposure draft climate standard from the ISSB. One notable difference between ESRS E1 and those proposed standards includes the focus on the requirement to report specifically on the basis of a Paris-aligned action[6]. How each of these standards evolve and develop over the upcoming consultation processes will be of particular interest.

### ESRS S5 (*Workers in the Value Chain*)

The ESRS S5 (*Workers in the Value Chain*) Working Paper (ESRS S5) sets out disclosure requirements for companies to report on how they affect workers in their value chain — in both positive and negative ways — through their own operations and their upstream and downstream operations, as well as business risks and opportunities related to companies' impacts and dependencies on value chain workers.

As one of a number of Working Papers in relation to a company's relationship with workers (ESRS 1–4 also cover various aspects of a company's relations with and treatment of its own workforce), ESRS S5 notes that it must be read in conjunction with these complementary standards and also certain CCS, and that disclosures should be made in the context of the requirements of these complementary standards.

## Conclusion

The CSRD is expected to play a key role in the European Green Deal and, in particular, the EU's Sustainable Finance Package, by ensuring that investors have access to a greater range and quality of non-financial information, including by requiring information reported under the CSRD to be machine readable for the purposes of comparability. The extension of the provisions of the NFRD in this regard come in response to the growing recognition that the ever-increasing number of ESG-focused investors feel that the current ESG-data that corporates provide is not adequately helpful, a recognition that is by no means exclusive to Europe.

Although the Working Papers are early-stage drafts that are likely to be amended considerably before entering into force, they provide insight into what the new, CSRD-led disclosure standards may look like for companies in the EU. This not only includes companies headquartered in the EU, but also large EU subsidiaries of multinationals, which gives the CSRD broad extra-territorial effect in certain respects. This extra-territoriality could create challenges for multinational companies, which could be subject to a variety of ESG reporting standards implemented in different jurisdictions, which in turn leads to challenges in consolidating reports across the corporate group.

The Working Papers' publication comes at a time when other non-financial disclosure standards are being promulgated and updated in the EU and worldwide at a considerable rate, and the interplay between these standards is likely to be a key consideration for companies across the globe.

For example, the Commission released the proposed CSDDD in February 2022, two weeks before the publication of ESRS S5. Many of the proposed disclosure requirements within ESRS S5 will likely link back to actions that would become mandated under the CSDDD, including assessing the extent to which material impacts occur on value chain workers as a result of the company's business model or strategy, and policies that the company may have in place to address those material impacts. However, the two Commission proposals do not yet cross-refer to each other in the context of supply chain diligence.

Further, on 21 March 2022, the SEC announced a proposed climate disclosure rule, which is currently undergoing a period of public consultation. Meanwhile, on 31 March 2022, the ISSB released the exposure drafts of the general requirements standard and climate related disclosures standard, which are also under public consultation. These new releases supplement the growing popularity of the TCFD Recommendations (which some countries including the UK have enshrined into law recently) and other proposed standards such as the UK's Sustainability Disclosure Requirements.

Among these clear differentiators are, as discussed above, the use of the single materiality (financial materiality) concept versus the double materiality concept, and a focus on climate-related issues versus wider ESG matters. Many opportunities for change, such as the public consultation and finalisation of the legislative negotiations of the CSRD, lie ahead before a number of these proposed standards are finalised, including those discussed in the Working Papers. However, the similarities and differences as they continue to emerge over the coming months and years will be worth monitoring. Also worth monitoring is how the CSRD develops over time, particularly how the final version avoids the risk of leading to exactly one of the problems it was designed to solve (i.e., too many standards and lack of consistency of disclosures across companies).

This Client Alert was written in conjunction with Viktor Josefsson of Forensic Risk Alliance, who has been deeply involved in the secretariat to the PTF-ESRS during the development of the Working Papers. Latham & Watkins greatly appreciates the insight and assistance provided by Viktor and Forensic Risk Alliance throughout the drafting process. https://www.forensicrisk.com/

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**Endnotes**

[1] Corporate Sustainability Reporting Directive (CSRD) proposal.

[2] Directive 2014/95/EU.

[3] 250 of more employees in the EU.

[4] The proposal is that ESG information is initially subject to a "limited" level of audit assurance.

[5] Notably, whilst the title of the disclosure requirement suggests transition plans should be in line with the Paris Agreement, the actual requirement for transition plans is more aggressive than the express goals of the Paris Agreement. This is because, whilst the Paris Agreement states that parties will "*pursu[e] efforts to limit the temperature increase to 1.5C above pre-industrial levels*", the express commitment is to holding the increase to "*well below 2C*". By comparison, the requirements of CSRD require transition plans to be aligned with 1.5C.

[6] See previous footnote in relation to Paris-alignment.