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CORPORATE SUSTAINABILITY REPORTING OBLIGATIONS IN THE EU AND UK

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CORPORATE SUSTAINABILITY REPORTING OBLIGATIONS IN THE EU AND UK

EU-corporations and non-EU corporations should prepare for new sustainability reporting obligations under the European Corporate Sustainability Reporting Directive (CSRD). The United Kingdom continues to develop its own revised and updated corporate sustainability reporting regime that will apply to UK companies.

Sustainability has been at the forefront of the European Union's legislative activities for the last few years. The United Kingdom has begun passing its own economy-wide sustainability regulations that are distinct from EU laws. With respect to corporates, the EU and UK have opted for extensive reporting obligations to meet stakeholder demands for more sustainability transparency and accountability. The EU and UK laws both no longer focus only on listed companies or public-interest companies (such as banks and insurers); instead, the new laws will be triggered if certain size thresholds (e.g., revenue or employee thresholds) are met on an individual or consolidated basis. Notably, from 2025, large private EU companies will be in scope of the CSRD. The EU laws are phased in over time, with the largest companies becoming subject to the new rules the earliest.

In addition, the CSRD incorporates an extraterritorial element by (additionally) making non-EU corporations subject to the new sustainability reporting obligations—if certain revenue thresholds are met in the EU. Therefore, multinational corporations headquartered outside the EU with subsidiaries in an EU country need to assess whether their respective subsidiaries will become subject to the new reporting obligations. Also, the added attention of legislators, law enforcement authorities, and public interest groups in environmental, social, and governance (ESG) in general and CSRD in particular increases the pressure on multinational corporations to pay closer attention to these topics, even if they may seem (geographically) far away.

The extensive sustainability disclosures that multinational corporations will have to make if they are in-scope of CSRD (or other such regimes) also bear a considerable risk of nurturing climate activism and action, since one of the policy drivers of transparency obligations is to equip stakeholders such as shareholders, investors, employees, activists, and public interest groups with sustainability information about a certain corporation so it may potentially be challenged.

The UK has started to enact its own corporate sustainability reporting regime. In common with the EU approach, whether companies are in scope of those laws generally depends on whether they meet certain size thresholds on an individual or consolidated basis. In particular, certain UK companies with a high energy consumption are already required to report their energy and greenhouse gas (GHG) emissions under the UK Streamlined Energy and Carbon Reporting Regulation (SECR) and provide a statement on how managers have had regard to certain sustainability matters as part of their management duties.

In addition, high-turnover UK companies are already required to report in line with the Task Force on Climate-Related Financial Disclosures (TCFD) framework. Furthermore, the UK has signaled that it will likely adopt the sustainability disclosure standards developed by the International Sustainability Standards Board (ISSB) and make it mandatory for certain UK companies to report in line with the ISSB standards.

It is important to acknowledge that many companies currently report sustainability information voluntarily, typically aligning with a particular reporting standard.

EU CORPORATE SUSTAINABILITY REPORTING – CSRD

The CSRD obliges certain companies to disclose sustainability information pursuant to certain European sustainability reporting standards. It came into force in January 2023 with EU member states having until July 2024 to transpose the first part of the new provisions into national law.

The CSRD vastly expands the types and number of companies that will be subject to sustainability reporting obligations going forward. While approximately 11,600 undertakings are currently subject to non-financial reporting obligations, following the implementation of the CSRD, it is estimated that approximately 49,000 undertakings will become subject to sustainability reporting obligations across the EU.

The target group of sustainability reporting obligations has formerly been largely public interest entities—i.e., EU and non-EU entities with securities listed on an EU-regulated market as well as EU insurance entities and financial institutions. With the CSRD, the sustainability reporting obligations will be expanded to companies only meeting certain size thresholds and thus trigger the expansion in the scope of reporting obligations. The reporting provisions will be phased in over several years, giving companies time to prepare.

The CSRD will apply to the following undertakings:

Phase 1: January 1, 2024:

1. Individual reporting obligations apply for financial years starting on or after January 1, 2024 (with a first publication in 2025 on 2024 data) to **large public interest entities** (**PIEs**). PIEs are essentially companies with more than 500 employees on average and

    a. have securities listed on an EU regulated market,

    b. are EU credit institutions,

    c. are EU insurance undertakings, or

    d. are EU companies designated as PIEs by individual EU member states.

2. In addition, a consolidated reporting obligation will apply to **large PIE EU parent undertakings** for financial years starting on or after January 1, 2024 (with a first publication in 2025 on 2024 data), if the parent undertaking is a PIE.

Phase 2: January 1, 2025:

1. Individual reporting obligations apply for financial years starting on or after January 1, 2025 (with a first publication in 2026 on 2025 data) to **large EU undertakings**—i.e., corporations that (on as single-entity level) exceed at least two of the following "**Largeness Criteria**" over two consecutive years:

    a. 250 employees

    b. €40 million (currently proposed to be increased to €50 million) net turnover (revenue)

    c. €20 million (currently proposed to be increased to €25 million) balance sheet total

2. A consolidated reporting obligation will apply to parent undertakings for financial years starting on or after January 1, 2025 (with a first publication in 2026 on 2025 data) if the

parent undertaking exceeds at least two of the above Largeness Criteria on a consolidated basis.

Phase 3: January 1, 2026:

An individual reporting obligation will apply for financial years starting on or after January 1, 2026 (with a first publication in 2027 on 2026 data) for **listed small- and medium-sized undertakings** (Listed SMEs)—i.e., EU undertakings which do not meet the Largeness Criteria, but which exceed at least two of the following criteria over two consecutive years:

1. Ten employees
2. €700,000 (currently proposed to be amended to €875,000) net turnover (revenue)
3. €350,000 (currently proposed to be amended to €437,500) balance sheet total

Phase 4: January 1, 2028:

The CSRD also contains an extraterritorial element. The sustainability reporting obligations will, in the future, also extend to multinational corporations whose ultimate parent undertaking is a non-EU company, if the following criteria are fulfilled:

1. The non-EU parent undertaking has at least one EU subsidiary which qualifies as a large undertaking or a listed SME (based on the criteria set out above); or
2. The non-EU parent undertaking has at least one EU branch that generates a net turnover of more than €40 million annually; and, if meeting either of these first two criteria,
3. The parent undertaking—on a group or individual level if there is no group—generates at least €150 million net turnover in the EU for two consecutive years.

If these criteria are met, the EU subsidiaries or EU branch(es) must draw up a sustainability report, which will have to include sustainability information at the group level of the ultimate non-EU parent company. In other words, the EU subsidiaries or EU branch will, in principle, need to report on sustainability matters on a worldwide level for the entire group.

ESRS

A new aspect of the CSRD is that undertakings subject to it will be obliged to report sustainability information in line with specific European Sustainability Reporting Standards (ESRS) which are being developed by the European Financial Reporting Advisory Group (EFRAG). The ESRS are intended to ensure that the sustainability information is understandable, relevant, truthful, verifiable, and comparable. The ESRS contain specific disclosure requirements and regulate how and whether companies must report, including whether a disclosure is compulsory or whether disclosure is only required, if the information is "material."

A first set of ESRS (which contains 12 standards relating to ESG) was adopted by the European Commission on July 31, 2023. These ESRS are sector-agnostic and apply to companies that are required to report as of January 1, 2024 and January 1, 2025. Sector-specific standards, proportionate standards for listed SMEs, and standards for entities subject to a worldwide sustainability reporting obligation were originally expected to be adopted by June 30, 2024, but are now expected to be pushed out by a further two years.

Under the first set of ESRS, ESRS 1 and ESRS 2 are cross cutting and set out general requirements and disclosures to be made. The objective of ESRS 1 is to provide an understanding of the architecture of ESRS, the drafting conventions and fundamental concepts used, and the general requirements for preparing and presenting sustainability information in accordance with the CSRD.

ESRS 1 also contains guidance on how to report on the undertaking and its organization and how the "double materiality" standard is to be applied. Accordingly, companies are obliged to report both on their own impact on people and the environment (inside-out perspective or "impact materiality") and on the impact of sustainability aspects on their business (outside-in perspective or "financial materiality"). Guidance is also provided on which information need not be reported on in the first years, transitional provisions, and incorporation by reference.

ESRS 2 establishes disclosure requirements on the information that the undertaking shall provide at a general level across all material sustainability matters. It includes disclosure requirements relating to the basis of preparation of the sustainability information, governance at the reporting entity, strategy, impact, risk, and opportunity management by the respective reporting entity, as well as sustainability metrics and targets.

In addition, the ESRS include topical standards. ESRS E1 to ESRS E5 contain environmental reporting standards covering (1) climate, (2) pollution, (3) water and marine resources, (4) biodiversity and ecosystems as well as (5) resource use and circular economy. ESRS S1 to ESRS S4 contain social reporting standards covering the topics (1) own workforce, (2) workers in the value chain, (3) affected communities, and (4) consumers and end users. Lastly, ESRS G1 contains governance specific reporting standards with respect to business conduct.

In addition, the CSRD requires a statutory auditor, an audit firm or independent accredited assurance provider to review whether the sustainability information is reported in compliance with ESRS. With regard to the scope and depth of the audit, an audit with limited assurance is initially planned, followed by an audit with reasonable assurance as of October 1, 2028. The limited assurance opinion should cover the compliance of the sustainability reporting with the CSRD and ESRS, the process carried out by the undertaking to identify the sustainability information, compliance with the reporting format, and taxonomy information. The EU Commission has until October 1, 2028 to decide whether to introduce a reasonable assurance audit. This would likely entail extensive procedures having to be adopted, including consideration of internal controls of the reporting undertaking and substantive testing.

Penalties and Enforcement

The CSRD as a whole, including the penalties for an infringement of the CSRD, still requires transposition into the national law of each individual EU member state. Under the directive, member states shall provide for penalties and take all the measures necessary to ensure that those penalties are enforced. The penalties provided for shall be effective, proportionate, and dissuasive. In line with the penalties set by member states for infringements of financial and non-financial reporting obligations already in place, it is to be expected that penalties will take the form of fines against corporate entities as well as criminal penalties against board members.

In addition, the extensive corporate sustainability information that multinational corporates will have to disclose due to the CSRD/ESRS will likely nurture climate activism by public interest groups. Corporate sustainability reporting is primarily aimed at equipping stakeholders, including shareholders, investors, employees, activists, and public interest groups with sustainability information about a corporation. It is to be expected that they will make use of it and challenge corporates on it. In addition, it is to be expected that proxy advisors will scrutinize the CSRD/ESRS disclosures of listed corporates, including non-EU corporates, especially once the worldwide reporting obligation kicks in. Enforcement risk for US-listed companies also stems from the US Securities and Enforcement Commission (SEC) if it starts to show interest in the sustainability disclosures US corporates need to publish in Europe. The added attention of legislators, law enforcement authorities and public interest groups in ESG in general and CSRD/ESRS particularly increases the pressure on multinational corporations to pay increased attention to these topics, even if they may seem (geographically) far away.

UK CORPORATE SUSTAINABILITY LEGISLATION

The following provides an overview of some of the sustainability reporting obligations in the UK.

Adoption of ISSB Reporting Standards in the UK?

On May 24, 2023, the Department for Business and Trade, working with the Financial Reporting Council (FRC), published a call for evidence for the review of the non-financial reporting requirements UK companies must comply with to produce their annual report and to meet broader requirements that sit outside of the Companies Act. It is likely that, going forward, the UK will require listed issuers and companies currently subject to TCFD reporting obligations to report in line with the sustainability standards developed by the International Sustainability Standards Board (ISSB).

ISSB STANDARDS

The ISSB was launched by the IFRS Foundation, which is the international body that governs the setting of global accounting standards adopted by the UK and over 140 other countries. In June 2023, the ISSB issued its inaugural sustainability standards, its mission being to formulate a comprehensive global baseline of high-quality sustainability disclosure standards. The ISSB standards were endorsed by the International Organization of Securities Commissions (IOSCO) on 25 July 2023 following an assessment co-led with the UK Financial Conduct Authority (FCA). The UK wants to be the first country in the world to endorse and adopt the standards for UK use and is calling on other countries to prepare for adoption of them in their jurisdictions.

The standards are composed of IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and IFRS S2 (Climate-related Disclosures) (collectively, ISSB Standards). The ISSB Standards are effective for annual reporting periods beginning on or after 1 January 2024.

IFRS S1:

- requires an entity to disclose information about all sustainability-related risks and opportunities that could reasonably be expected to affect its cash flows, access to finance, or cost of capital;
- prescribes how an entity prepares and reports its sustainability-related financial disclosures, setting out general requirements for the content and presentation so that the information is decision-useful for existing and potential investors, lenders, and other creditors; and
- in particular, requires disclosures in four core areas (which will be familiar to TCFD users) enabling users to understand the entity's governance process, controls and procedures, strategy, and risk management processes for managing sustainability-related risks and opportunities as well as performance regarding such risks and opportunities, including progress towards voluntary or mandatory targets.

Notably, a company is required to disclose "material" information about such risks and opportunities that could reasonably be expected to affect its prospects—i.e., single, not double, materiality. This contrasts with the EU double materiality approach under CSRD and the single materiality approach in the United States. Accordingly, the UK and US would share a single materiality approach.

Any company applying IFRS S1 must apply IFRS S2. IFRS S2 focuses on climate-related disclosures and broadly aligns with the TCFD. IFRS S2 requires an entity to identify and disclose material information about climate-related risks and opportunities that could affect its prospects enabling users to understand its governance, strategy, risk management, and performance related to climate.

Notably, a company must disclose its total GHG emissions across Scopes 1, 2, and 3. Asset managers, banks, and insurers are required to disclose information about those emissions associated with its investments, so-called "financed emissions." To help companies transition, Scope 3 disclosures (including "financed emissions") may be omitted for the first year.

CURRENT UK CORPORATE SUSTAINABILITY REPORTING OBLIGATIONS

The UK has enacted the following sustainability-related reporting obligations to which UK corporates are already subject.

Streamlined Energy and Carbon Reporting

In the UK, since April 2019, **large UK companies** and **large UK parent companies** have been subject to Streamlined Energy and Carbon Reporting (SECR)[1] if they exceed at least two of the following three largeness criteria on an individual or consolidated basis:

1. Turnover of £36 million,
2. Balance sheet total of £18 million,
3. 250 employees,

and additionally, consumed more than 40,000 kWh of energy in the UK during the year.

Pursuant to SECR, directors are required to include in their directors' report information on UK energy use (as a minimum, gas, electricity, and transport, including UK offshore area); associated GHG emissions; previous year's figures for energy use and GHG emissions; at least one intensity ratio; and energy efficiency action taken and methodology used in calculation of disclosures.

On October 19, 2023, the Department for Energy Security and Net Zero published a "call for evidence" on UK GHG emissions reporting, seeking views on SECR and the costs, benefits, and practicalities of Stage 3 GHG emissions reporting. Feedback gathered will inform a review of SECR with findings scheduled for publication in April 2024.

Section 172(1) Statement Under Companies Act 2006

In addition, for financial years starting on or after January 1, 2019, **large UK companies** and **large UK parent companies** (as defined above) must publish a Section 172(1) statement in their strategic report, which describes how directors have had regard to certain sustainability matters set out in S.172(1)(a) to (f) when performing their management duties. The information that any particular company should include in their Section 172(1) statement will depend on the individual circumstances of each company, but guidance states that companies will probably want to include information on some or all of the following:

- The issues, factors, and stakeholders the directors render relevant in complying with Section 172(1)(a) to (f) and how they have formed that opinion
- The main methods the directors have used to engage with stakeholders and understand the issues to which they must have regard

[1] The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018 amending the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 with effect from 1 April 2019.

- Information on the effect of that regard on the company's decisions and strategies during the financial year

Climate-Related Financial Disclosures

Pursuant to the Climate-related Financial Disclosure Regulation,[2] **high-turnover UK companies** or **high-turnover UK parent companies,** among others, are required to include in their strategic report their climate-related financial disclosures drawn up in line with the recommendations of the TCFD as of financial years starting on or after April 6, 2022 with the first reports being published in 2023.

High-turnover UK companies are large UK companies and LLPs that exceed at least two of the following largeness criteria:

1. Turnover of £36 million,
2. Balance sheet total of £18 million,
3. 250 employees,

and additionally have 500+ employees and turnover of £500 million+.

Enforcement

The Conduct Committee of the FRC has the legal authority to review a directors' report and a strategic report and, if the report fails to comply with the statutory requirements, to go to court and compel a company to revise its report. The court can order that the costs incurred by the company in preparing a revised report are the responsibility of the directors personally. However, where possible, the FRC operates by agreement with companies whose reports it reviews without having to resort to the courts.

In case of a failure to comply with the requirement to prepare a directors' report or a strategic report, a criminal offence (punishable by a fine) is committed by every person who both

- was a director of the company immediately before the end of the period for filing accounts and reports for the financial year in question; and
- failed to take all reasonable steps for securing compliance with that requirement.

Where a company publishes a directors' report or strategic report that contains untrue or misleading statements or omits material facts or there is dishonest delay in publication, and a person acquires, holds, or disposes of shares in the company in reliance on the information and suffers loss as a result, the company and/or the directors of the company may incur liability under statute. If the company's auditor has reviewed the climate-related financial disclosures and determines that these contain uncorrected material misstatements, this should be recorded in the auditor's report.

INTEROPERABILITY BETWEEN DIFFERENT CORPORATE SUSTAINABILITY REPORTING STANDARDS

The above provisions demonstrate that, going forward, corporates will be subject to different sustainability reporting regimes. If the UK decides to make it mandatory for certain companies to report under the ISSB Standards, two important jurisdictions in Europe would have different regimes

[2] The Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022 amending the Companies Act 2006 with effect from April 6, 2022.

in place with which multinational corporations would have to comply, if the corporate group or individual subsidiaries fall under the respective rules. The difference between UK and EU laws, however, is only the tip of the iceberg, as more and more legislators mandate sustainability disclosure rules. In the US, for example, the state of California has already begun mandating certain sustainability disclosures, while issuers are still waiting for the SEC to publish its long-awaited climate rules.

The interoperability and harmonization of different corporate sustainability reporting standards will be of the utmost importance going forward. If multinational corporates have to comply with a multitude of regional standards, requesting different data points, it would potentially create challenges for existing reporting structures and certainly create extra costs. It is the right approach, therefore, that the EFRAG aspired to ensure a high level of alignment of the ESRS with the ISSB Standards.

Nevertheless, some key differences exist between their respective standards and ISSB is expected to produce materials which help companies navigate them. One of the most notable differences is that under the ISSB, corporations need to report based on single materiality, whereas the ESRS have adopted a double materiality approach. In addition, the ESRS and the ISSB Standards are new, while large corporations often already report under certain sustainability frameworks, most notably the TCFD recommendations and the Global Reporting Initiative (GRI).

It may therefore be expected that the European Commission will soon adopt decisions on which sustainability reporting standards it deems "equivalent" to the ESRS. If a positive equivalence decision is adopted, corporates would not need to report under the ESRS, but reporting under the "other" sustainability framework would be sufficient. However, it is to be expected that in order for another reporting standard to be deemed equivalent, it would have to include also social and governance reporting obligations (not just climate and environmental obligations).

The question remains as to whether a standard embracing single materiality (such as the ISSB Standards) could be deemed equivalent. At the moment, it seems the GRI Standards are most likely to be a runner-up to be deemed "equivalent."

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