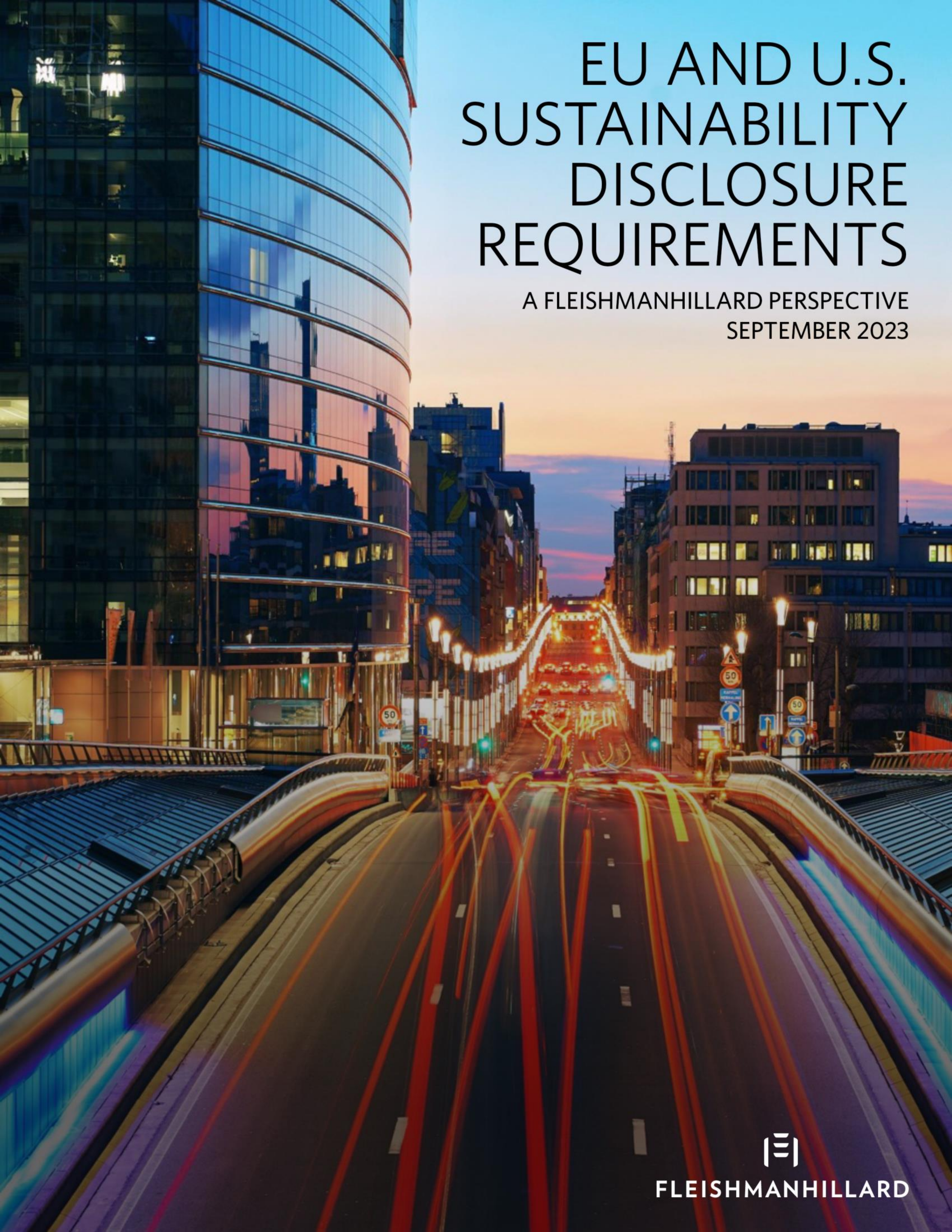

EU AND U.S. SUSTAINABILITY DISCLOSURE REQUIREMENTS

A FLEISHMANHILLARD PERSPECTIVE
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FLEISHMANHILLARD

This briefing outlines the fundamental requirements stemming from the EU's sustainability reporting requirements and the upcoming U.S. SEC disclosure rule.

The EU Corporate Sustainability Reporting Directive (CSRD)

The EU's CSRD introduces a significant step change in sustainability disclosure for both EU and non-EU companies. It will apply to all large companies as defined by the EU accounting rules (those that surpass at least two of the following three criteria: balance sheet total of €20 million, net turnover of €40 million, and 250 employees) regardless of whether they are listed, as well as to all companies whose securities are admitted to trading on an EU regulated market (including SMEs).

The EU text requires distinctly **granular reporting on the impact of ESG factors on the undertaking, as well as the undertaking's impact on the environment and society**, referred to as "double materiality." Reporting is to be done through a company's management report, covering data from the last financial year, and a separate report for non-EU entities – *see below for non-EU entity reporting requirements.*

EU Sustainability Reporting Standards

Reporting under the CSRD takes place via specific EU sustainability reporting standards (ESRS). A set of "sector-agnostic" ESRS is set to apply from Jan. 1, 2024. These standards outline detailed general (ESRS 2), environmental (E1-5), social (S1-4), and governance-related (G1) reporting requirements for all companies in scope – *see here, here and here.*

Importantly, **all companies are required to report against ESRS 2**, which includes disclosures on their sustainability strategy, business model, value chain and governance arrangements in order to understand exposures to ESG-related impacts, risks and opportunities. For the remaining ESRS, companies are generally required to undertake a **"materiality assessment,"** which is subject to external assurance. If assessed material, a company is required to report against this standard or data point.

It is not mandatory to disclose which indicators have been deemed non-material, except for climate change-related standards (E1). If E1 data points are assessed as non-material, companies are required to provide a detailed explanation of the assessment and forward-looking analysis of when the data point could become material. Additionally, companies are allowed to use estimates if uncertainties are adequately explained, and they may omit classified, sensitive and intellectual property information even if considered material.

Additional "sector-specific" ESRS are to be developed. These standards are expected to cover a wide range of sectors including healthcare and services, medical instruments, pharma, and biotechnology as well as agriculture, road transport, oil, gas and mining.

International interoperability

The CSRD requires that EU ESRS take account of the work done by the IFRS at the international level. The IFRS adopted its first set of sustainability reporting standards on June 26, 2023 – *see here, here and here.* Interoperability between EU and international frameworks, such as the IFRS Foundation's International Sustainability Standards Board (ISSB) has been and will remain an important point of focus throughout the ESRS' development. While a certain degree of interoperability between the two reporting frameworks has been achieved, both parties have expressed their intention to continue cooperation, particularly by streamlining definitions, for example of financial materiality, and delivering interoperability guidance.

Extraterritorial impact

The CSRD also applies to third-country undertakings, where these have a net turnover of €150 million in the EU, and either a "large" subsidiary or a branch that generates €40 million net turnover. It will apply from Jan. 1, 2028, with first reporting due in 2029. Reporting needs to be done at the consolidated level of the non-EU parent, and included in a separate report, as opposed to reporting by EU-based entities (who need to report in the management report). Separate reporting standards for non-EU companies are due to be adopted by June 30, 2024.

Next steps

- **Jan. 1, 2024:** Start phased-in reporting requirements with CSRD applying from:
    - **Jan. 1, 2024** (first report due in 2025) — for companies already subject to NFRD.
    - **Jan. 1, 2025** (first report due in 2026) — for large companies newly in scope of the CSRD.
    - **Jan. 1, 2026** (first report due in 2027) — for listed SMEs, small and non-complex banks and captive (re)insurance companies (with a two-year possible opt-out for listed SMEs).
    - **Jan. 1, 2028** (first report due in 2029) — for non-EU companies scoped in through EU subsidiaries and branches.

The U.S. SEC Climate Risk Disclosure Rules

The U.S. Securities and Exchange Commission (SEC) in March 2022 issued a draft proposal to enhance and standardize climate-related disclosures for investors, illustrating the increasing emphasis investors are placing on climate-related risks and opportunities when evaluating companies. The Commission planned to release the final rules last year, but that timeline has continued to slip due to pushback from politicians who object to the proposed rule on principle and some corporations who view it as expensive, cumbersome and far-reaching. Experts now expect the final rules to come out in the second half of 2023.

The proposed rules — when enacted — will represent a significant change for public companies as they expand substantially on SEC climate-risk reporting rules already in place.

The proposed rules would:

- Require additional reporting on the governance and oversight processes of climate-related risks by the company board and more specificity on the impacts of climate change on their financial statement line items.
- Require companies to provide footnotes to individual items on their financial statements if they are affected by climate-related impacts (if that financial impact equates to 1% or more of that given line item).
- Require companies to report whether they have a climate transition plan including goals and targets and, if they do, a description of how they intend to reach them and annual updates on progress, as well as whether the plan relies on renewable energy credits and/or carbon offsets.
- Require companies to disclose information about direct greenhouse gas (GHG) emissions (scope 1) and indirect emissions from purchased electricity or other forms of energy (scope 2), as well as certain types of GHG emissions from upstream and downstream activities in its value chain (scope 3).

The proposed new rules are largely aligned with voluntary climate reporting guidelines issued by the Task Force on Climate-Related Financial Disclosures (TCFD). The SEC has published a fact sheet with detailed information.

In addition to the SEC rule, the state of California has recently passed legislation that would require companies to disclose direct and indirect GHG emissions, including scope 3 emissions, on an annual basis. The bill goes beyond the anticipated SEC rules and could potentially apply from 2026.

Opposition and political context

Since the initial announcement of the SEC rule, many companies and Republican lawmakers have criticized the proposed rules for going too far, while environmentalists claim the rules do not go far enough. Investors and Democrats have applauded the action. The SEC has already received legal threats from nearly two dozen attorneys general, including those in Alabama, Arizona, Florida, Georgia and West Virginia, who have argued that the rule would be barred by a U.S. Supreme Court decision that found congressional approval is needed for a major shift in agency policy. This claim of SEC overreach was voiced by Republican members of Congress in a formal letter sent to the SEC Chair Gary Gensler at the beginning of the year. As a result of the pushback — and the more than 15,000 comments on the rule that the SEC has received, Gensler has said the agency is considering making adjustments to the scope 3 rule.

Where critics have taken the most issue with the rules is scope 3 emissions reporting and the 1% threshold for footnoting climate impacts on financial statement line items. Scope 3 emissions, which comprise the majority of most companies' climate impact, are quite difficult and expensive to calculate. In this context, the California bill is expected to raise similar controversy and practical difficulties around the disclosure of scope 3 emissions.

Another challenge related to the SEC rule is while many companies have made low- or zero-carbon pledges, many don't yet necessarily have a fully developed plan for how they will get there. The proposed rules require not only a description of the plan, but companies that have stated goals would also now be required to report on their progress against those goals annually, making it a much more complicated and difficult task for companies to comply with.

Additionally, this requirement would shine a light on the credibility of the transition plans and targets, given companies would have to report how much of their plan and progress relies on carbon credits or renewable energy credits as opposed to absolute GHG reductions.

Conclusion

The SEC proposal was originally published with a target deadline of October 2022 for final rule. But due to the pushback and feedback, the latest estimate is that the rules will be released this fall (2023). The SEC may also be waiting for Congress to end its work for the year, which would prevent Gensler from being called up to Capitol Hill to testify by hostile Republican-led committees in the House. This has effectively pushed the start year of this reporting requirement to the 2024 fiscal year, which begins October 1, instead of the originally proposed 2023 fiscal year. Once finalized, there is likely to be a slew of lawsuits contesting the rule. So, there's still uncertainty as to when the rules will start in any practical sense.

Many companies will have to make significant internal infrastructure changes to comply with these proposed new rules. Companies already issuing robust reporting based on TCFD voluntary guidelines will have a much easier time of it.

The SEC's proposed rules, however, pale in comparison to what will soon be required for companies headquartered in the EU and about 10,000 non-EU companies with a large EU footprint under the EU's Corporate Sustainability Reporting Directive.