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EU Commission Adopts Final Sustainability Reporting Rules

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On July 31, 2023, the European Commission announced its adoption of the European Sustainability Reporting Standards ("ESRS") for companies subject to the Corporate Sustainability Reporting Directive ("CSRD"). The long-awaited ESRS represent a significant milestone in the implementation of the CSRD, which aims to update the existing EU sustainability reporting framework and expand the number of companies required to report on sustainability-related impacts, opportunities and risks.

The European Financial Reporting Advisory Group ("EFRAG") was tasked with preparing the ESRS, and in November 2022, it submitted its final draft to the Commission in the form of technical advice. The Commission made certain modifications to the framework, including the materiality approach, the phasing-in of certain requirements, the conversion of certain requirements into voluntary disclosure, the introduction of greater flexibility in a number of disclosure requirements, and the introduction of technical modifications. The Commission's adoption of the ESRS is effected by way of the Delegated Regulation on the European Sustainability Reporting Standards. The CSRD, scheduled to apply from the beginning of 2024, replaces the 2014 Non-Financial Reporting Directive (the "NFRD") and introduces more comprehensive reporting requirements on environmental, social and governance issues. Compliance with the CSRD will be mandatory for all large European companies, and companies listed on EU-regulated markets including EU subsidiaries of non-EU parent companies.

Key Provisions of the ESRS

Materiality-based Reporting: The ESRS retain the mandatory nature of some sustainability disclosures but introduce a materiality-based reporting approach. While general disclosures under ESRS 2 are compulsory for all reporting entities, specific disclosure requirements will apply only if deemed material to a company's business model and activity. The materiality assessment process must undergo external assurance.

Phase-in for Selected Disclosures: The Commission has introduced additional phase-ins for certain reporting requirements, particularly for companies with fewer than 750 employees. This approach aims to ease compliance for smaller companies. The phase-ins mainly apply to reporting on biodiversity and social issues.

Voluntary Disclosures: Some data points have been designated as voluntary, including reporting a biodiversity transition plan and specific indicators related to the workforce.

Interoperability: The ESRS were developed with a high degree of alignment with the International Sustainability Standards Board ("ISSB") and the Global Reporting Initiative ("GRI") standards. The Commission emphasized that companies required to report under ESRS on climate change will report similar information to those using the ISSB climate standard, but ESRS go further by providing additional information on impacts relevant for stakeholders beyond investors.

Next Steps and Scrutiny

The adopted ESRS delegated act will undergo a two-month scrutiny period in the EU Parliament and Council. These bodies have the authority to reject the ESRS cannot make amendments. Once the scrutiny period concludes, companies subject to the NFRD and large non-EU listed companies with over 500 employees will be required to start reporting under ESRS for the financial year 2024, with the first reports due in 2025. Other large companies will follow a year later, and listed SMEs will start issuing their first ESRS sustainability statements in 2027, with the option to opt out for up to two years.

Final Thoughts

Although not entirely without criticism, the adoption of the ESRS represents a significant development in the EU's sustainable finance agenda. We have frequently discussed the importance of reporting and disclosure frameworks, without which investors are unable to compare sustainability credentials from company to company. Even following adoption of the ESRS, however, there remains a continuing need to "align" with international standards, including the ISSB, and promote consistency with other EU directives. While a jurisdictional and, to some extent, global alignment process will continue, it remains to be seen how long it takes and the extent to which consensus ultimately is achieved. On a positive note, the ISSB has agreed to reference the ESRS within the S1 appendix "as a source of guidance companies may consider, in the absence of a specific ISSB standard, to identify metrics and disclosures if they meet the information needs of investors."

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