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EU Adopts Long-Awaited Mandatory ESG Reporting Standards

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In January 2023, the European Union adopted the Corporate Sustainability Reporting Directive (CSRD), which requires EU and non-EU companies with activities in the EU to file annual sustainability reports alongside their financial statements. These reports must be prepared in accordance with European Sustainability Reporting Standards (ESRS).

On July 31, 2023, the European Commission adopted the first set of ESRS. The ESRS soon will become law and will apply directly in all 27 EU member states, but not in the UK. Companies will need to report in compliance with these new ESRS as early as the 2024 reporting period.

The standards are notable for their breadth and granularity, going well beyond the reporting requirements in other mandatory and voluntary ESG reporting frameworks. It is clear that companies in scope need to start getting ready to report to these new ESRS now.

For further details on the companies covered by the CSRD, see Cooley's related October 2022 client alert.

The ESRS

The ESRS set out detailed reporting requirements for EU companies in scope of the CSRD, including EU subsidiaries of non-EU companies. The ESRS cover:

1. General reporting principles.
2. A list of mandatory disclosure requirements for EU companies related to the identification and governance of sustainability matters.
3. The 10 ESG topics where disclosure is required, subject to a materiality assessment.

While this is the first set of ESRS, further sets of standards also will be adopted in the near future for specific industry sectors, small and medium-sized enterprises (SMEs) and non-EU parent companies.

Together, the CSRD and ESRS require companies to:

- Perform materiality assessments on each sustainability topic applying the **double materiality principle** to work out which information should be reported. (In line with double materiality, companies must report if sustainability information is material from either a financial or an impact perspective, taking account of people and the environment.)
- Report on the material **impacts, risks and opportunities** (IROs) identified in the company's own operations, those of its group and those of its **upstream and downstream value chain**.
- Provide **metrics and targets** for material sustainability topics and connect these to their financial reports.
- Have their sustainability disclosures **audited by an independent third-party auditor** before they are filed with the relevant authority.

General requirements

ESRS 1 on 'General Requirements' explains the process requirements that apply to all companies reporting under these standards. For example, it explains what is meant by double materiality and reporting boundaries, as well as the extent to which a company must report on its value chains, due diligence expectations, the required quality of quantitative and qualitative data (including the use of estimates), the need for consistency with the company's financial statement disclosure, and the overall report structure.

General disclosures

ESRS 2 on 'General Disclosures' lists all the mandatory disclosures that all in-scope companies must report on, irrespective of materiality. This standard includes disclosures on how sustainability-related performance is integrated into the company's incentive schemes, statements on its due diligence processes and descriptions of the processes used to identify and assess materiality. Disclosures on key performance indicators prescribed by the EU Taxonomy Regulation also are required.

Topical ESRS

Materiality assessments: For the topical ESRS that cover the 10 ESG topics set out in more detail below, a materiality assessment is the starting point for reporting. Companies are required to assess and report on 'material' sustainability-related IROs in their value chains under each of the 10 topical standards. If, following the materiality assessment, a given sustainability matter is material from either a financial or impact perspective, the company must disclose against the relevant topical ESRS. The European Commission has been keen to emphasize that reporting on material sustainability matters is not voluntary. The conduct of materiality assessments may require significant advanced planning, including gathering information related to value chain impacts. Companies still will be required to gather sustainability information from their value chains even if, once assessed, they ultimately conclude that the information is not material enough to require reporting.

Where a company has determined that a topical ESRS is not material, it is not required to report information under that standard. However, unlike the other topical ESRS, if a company judges climate-related disclosures (E1) to be immaterial, the company must provide a detailed justification.

Permitted exclusions are very limited, and where a company relies on an exemption, it must disclose this to be the case.

The table below provides an overview of the content for each adopted topical ESRS.

Environmental	
E1 Climate change	• Disclosures on climate change mitigation, climate change adaptation and energy consumption. • Disclosures on climate change mitigation relate to the company's efforts to limit global warming to 1.5°C in line with the Paris Agreement. • Disclosures on Scopes 1, 2 and 3 greenhouse gas emissions and transition risks.
E2 Pollution	• Disclosures on pollution of the air, water, soil, living organisms and food resources, as well as the use of substances of concern and microplastics. • This standard covers pollutants generated or used during production processes and those that leave facilities as emissions, products, or as part of products or services.
E3 Water and marine resources	• Disclosures on consumption, withdrawal and discharge from and into water (including ground and surface water) and marine resources. • This standard also requires consideration of the extraction and use of marine resources.
E4 Biodiversity and	• Disclosures covering areas such as the drivers of biodiversity loss, impact on species, and

ecosystems	impacts and dependencies on ecosystems.
E5 Circular economy	• Disclosures on resource inflows, outflows, waste, resource optimization and the risks of the transition to a circular economy. • A circular economy is one in which the value of products, materials and other resources in the economy are maintained for as long as possible, enhancing their efficient use in production and consumption, thereby reducing the environmental impact of their use, minimising waste and the release of hazardous substances at all stages of the product life cycle.
Social	
S1 Own workforce	• Disclosures on the company's own workforce – including freedom of association, working conditions, access to equal opportunities and other work-related rights.
S2 Workers in the value chain	• This standard is similar to ESRS S1 in content but requires consideration of the workers in the company's value chain(s).
S3 Affected communities	• Disclosures on the impact of a company's own operations and value chain – including its products and services, impact on indigenous rights, civil rights, and social and economic rights, including water and sanitation, among others.
S4 Consumers and end-users	• Disclosures on the impacts of a company's products and/or services on consumers and end-users – including access to quality information, privacy and the protection of children. • Companies are not required to consider the unlawful use or misuse of products or services.
Governance	
G1 Business conduct	• Disclosures on anti-corruption and anti-bribery practices, the protection of whistle blowers, political lobbying and the management of relationships with suppliers (including payment practices).

Sector-specific standards and additional forthcoming standards

The ESRS outlined above do not represent the entirety of potential disclosure obligations under the CSRD. Sector-specific standards which will apply in addition to the current ESRS are expected to cover sectors such as textiles, information technology, electronics, and pharmaceuticals and biotechnology. These standards would create additional disclosure requirements related to topics of particular materiality for specific industries. Drafts

of these standards initially were scheduled for 2023 – 2024.

Other sets of sustainability standards will be adopted by the EU in the coming years for SMEs and non-EU parent companies.

Further application guidance also can be expected in the coming months. The European standards body – the European Financial Reporting Advisory Group – is currently developing additional guidance on how companies can perform the double materiality assessment and the extent of value chain information required under the ESRS.

Key elements for businesses

Companies in scope of the CSRD should start getting ready for ESRS reporting now, as it may take some time to perform materiality assessments and set up systems to gather the audit-ready data needed for their reports. Key elements for businesses are outlined below.

1. **Centrality of materiality assessments**

   Companies will need to front-load work in this area to determine the scope of their reporting requirements under each of the topical ESRS. Outside advisers likely will play a key role in helping companies design relevant processes, which must include an analysis of value chains and double materiality – and likely will differ substantively from companies' existing sustainability reporting frameworks or risk management systems.

2. **Process cannot be neglected**

   The ESRS are very detailed on **what** companies should report on and **how** they should report. This means that most companies will need to assess whether their existing sustainability diligence and reporting practices comply with the CSRD, even if they already report on some or all of the areas covered by the topical ESRS. Similar to US Securities and Exchange Commission (SEC) cybersecurity and climate rules, as well as the widely used Task Force on Climate-Related Financial Disclosures (TCFD) and CDP climate disclosure frameworks, the ESRS has a significant focus on disclosures related to the governance of sustainability matters. Companies should be attentive to preparing for the mandatory process and governance disclosures in ESRS 2.

3. **Importance of climate materiality**

   Perhaps the most notable feature of the adopted ESRS is the move away from proposed mandatory reporting on climate change, including the disclosure of scopes 1, 2 and 3 greenhouse gas emissions. Nonetheless, in practice, we anticipate that most companies will need to report on climate change, given the breadth of the double materiality framework and the need to justify any decision to exclude climate reporting – and have that justification pass audit. At the same time, we are seeing increased investor and customer demands for climate data, meaning, in practice, many companies will be making these disclosures anyway.

4. **Greater consistency with other ESG reporting frameworks, but gaps remain**

   Although the SEC's final climate rule is not expected until later this year, the ESRS differ from the SEC's current and proposed rules in numerous substantive and methodological areas. Divergences include how the ESRS approach to value chain reporting, the need for impact materiality assessments and the need to report on a broader set of sustainability topics. The ESRS also are broader than just climate disclosures and extend well beyond the current limited SEC requirements related to human capital and governance matters. For US companies already aligning voluntarily with frameworks such as the Global Reporting Initiative, Sustainability Accounting Standards Board or TCFD, the ESRS also contains numerous significant differences in subject matter and methodology.

   Similarly, while improvements have been made to better align the ESRS and International Sustainability Standards Board (ISSB) standards – IFRS S1 and IFRS S2, published June 2023 – companies should not assume that a CSRD-compliant report will automatically meet all the requirements under the ISSB

standards, and vice versa. For UK and Singapore companies, this is particularly relevant. On 2 August 2023, the UK government confirmed that the incoming UK Sustainability Disclosure Standards will be based on the ISSB standards. These new UK sustainability reporting requirements may apply to companies as early as July 2024. A similar proposal has been made in Singapore, where certain companies may be required to comply as early as 2025. The publication of a summary comparing the ESRS to the ISSB standards is expected in the coming months. As a result, we recommend that companies conduct gap assessments of their current voluntary reporting or other regulated disclosures against the ESRS to identify areas where additional work will be required.

If you have any questions or would like support adjusting to this new reporting regime, please contact a member of Cooley's international ESG and sustainability advisory team.

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