SAI360

EBOOK

EU CSRD: Meeting the new reporting standard

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> "For the first time…we are putting sustainability reporting on equal footing with financial reporting… We need accurate and reliable information to ensure investments are being made towards a more sustainable future. Companies need the information to plan their transition paths. And investors need the information to have clarity about what they're investing in and to combat greenwashing."
>
> – European Commission

Introduction

Climate change represents an existential risk to Europe and the rest of the world. While global media outlets have made the ecological, health and lifestyle threats clear, lesser known, yet equally impactful risks face corporations of all sizes. In fact, according to research conducted by Ernst & Young (EY) and the Institute of International Finance (IIF); 91 percent of Chief Revenue Officers (CROs) see climate risk as the most important emerging risk facing firms over the next five years[1], and 96 percent say climate risk is the number one concern of their board of directors.

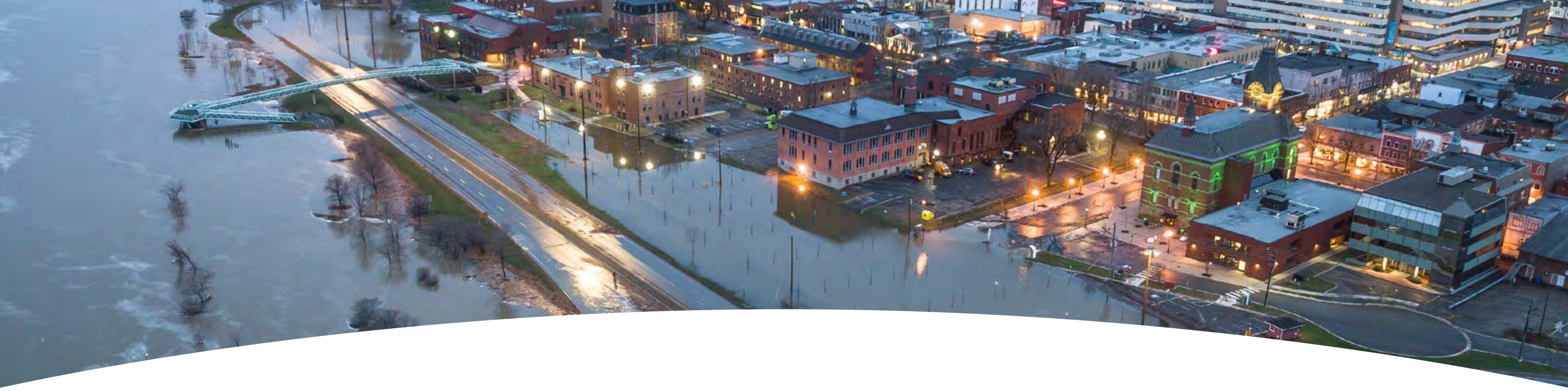
THESE CLIMATE RISKS BROADLY FALL WITHIN TWO PRIMARY CATEGORIES

1) **Physical Risk:** Climate change can result in more frequent and severe weather events such as hurricanes, droughts, and floods, leading to increased damage to infrastructure and property.

2) **Transition Risk:** The transition to a low-carbon economy can result in stranded assets, such as fossil fuel reserves, and the decline of certain industries, leading to losses for investors and companies.

Beyond environmental impact, companies' actions also have a significant impact on the welfare of EU citizens, in terms of products and services, jobs and opportunities, working conditions and human rights. EU citizens therefore expect companies to understand the positive and negative impacts they have on society and the environment, and to prevent, manage and mitigate these across all of their operations.

1. https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/banking-and-capital-markets/ey-resilient-banking-capturing-opportunities-and-managing-risks-over-the-long-term.pdf



THE NON-FINANCIAL REPORTING DIRECTIVE: A BRIEF HISTORY

Issued by the EU in 2018, the Non-Financial Reporting Directive (NFRD) is a directive that requires certain large companies to disclose non-financial information in their annual reports.[4] It applies to organizations with more than 500 employees listed on a regulated EU market, or firms considered to be of “public interest” which may not necessarily be listed, namely credit institutions and insurance undertakings. Importantly, these thresholds apply at group level, meaning the figures are aggregated across all subsidiaries.

The ultimate aim of the NFRD is to improve transparency and accountability in corporate reporting and provide stakeholders and investors with non-financial information to assess the climate-related risks to the firm. Under NFRD, organizations are required to disclose a range of non-financial information relating to human rights, environmental protection, anti-corruption and bribery, gender, education, age diversity, social responsibility, and the treatment of employees.

The NFRD is not without its shortcomings, however, and the directive has been widely criticized for its narrow eligibility and lack of standardized reporting which has left room for ambiguity, making it difficult to benchmark performance or make cross-industry comparisons.

Sustainability disclosures exist as an important tool in mitigating the aforementioned climate risks and have been highlighted as a primary goal within the Financial Stability Board’s (FSB) Roadmap for Addressing Climate-Related Financial Risks[2]. The FSB calls for globally consistent, comparable, and decision-useful public disclosures by firms pertaining to their climate-related risk exposure.

2. https://www.fsb.org/wp-content/uploads/P070721-2.pdf
3. https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464
4. https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/654213/EPRS_BRI(2021)654213_EN.pdf

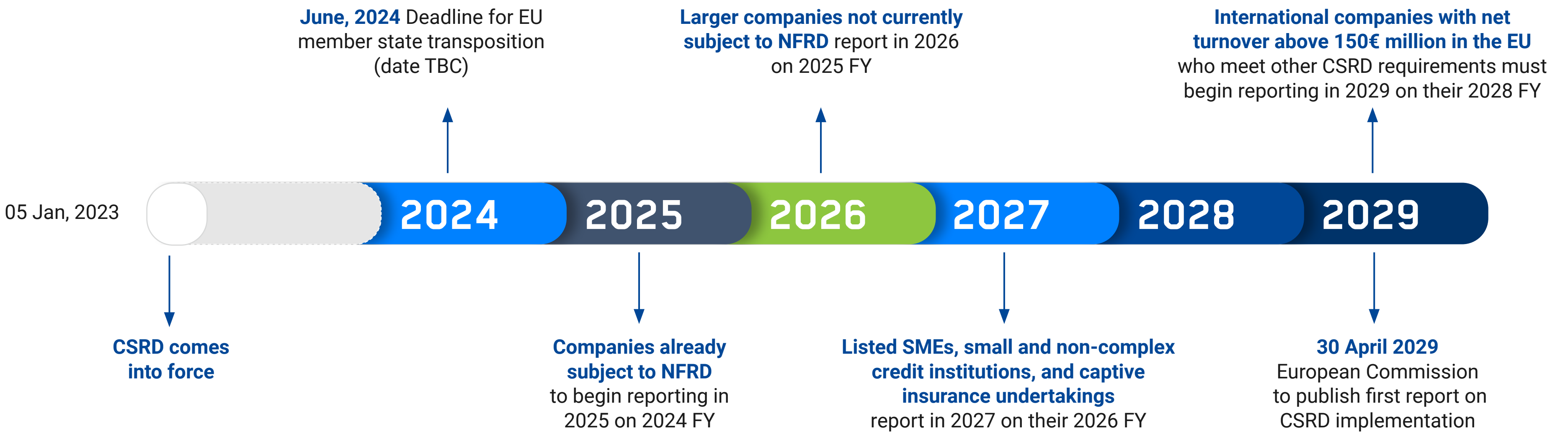
Corporate Sustainability Reporting Directive

The Corporate Sustainability Reporting Directive[3] (CSRD) forms part of the broader European Green Deal to make the European Union (EU) climate-neutral by 2050. The CSRD intends to strengthen and streamline the reporting requirements for companies across the EU. It serves to amend and extend the obligations of its predecessor - the Non-Financial Reporting Directive (NFRD) - by providing investors and stakeholders with more reliable and comparable information on companies' environmental and social impacts.

The CSRD serves to address the weaknesses of NFRD by increasing the quality, comparability and consistency of sustainability reporting, introducing more detailed requirements and reporting standards for companies. The new directive significantly increases the number of in-scope firms from around 11,700 to almost 50,000 by including companies exceeding at least two of the following criteria:

- The company's total assets on the balance sheet exceed €20 million
- The company's net turnover for the financial year exceeds €40 million
- The company has more than 250 employees on average during the financial year

A TIMELINE OF CSRD IMPLEMENTATION



A NEW REPORTING STANDARD

The CSRD requires companies to report sustainability information in line with the European Sustainability Reporting Standards (ESRS). Developed by the European Financial Reporting Advisory Group (EFRAG), the ESRS is designed to ensure that sustainability information is reported across the business and material Environmental, Social, Governance (ESG) impacts, risks, and opportunities are identified and managed.

The first set of ESRS[5] are designed to ensure that sustainability information is reported in a carefully articulated manner (see ESRS Reporting Structure to right).

The cross-cutting requirements (ESRS1 and ESRS2) dictate exactly what and how firms are expected to analyze and report. The subsequent topical standards highlight the particular areas of focus under each of the three pillars of ESG.

ESRS REPORTING STRUCTURE

Cross-cutting requirements

ESRS 1 - General Requirements
Companies are to disclose certain sustainability information irrespective of their materiality

ESRS 2 - General Disclosures

1. Governance
Controls and procedures to monitor and manage sustainability impacts and risks

2. Strategy
How the corporate strategy interacts with material impacts (including strategy for addressing them)

3. Impact, risk and opportunity management
Process for identifying, assessing and mitigating

4. Metrics and targets
Specific performance targets and measurements

Sector Agnostic Topical Standards

Environment	Social	Governance
Climate change	Own workforce	Business conduct
Pollution	Workforce in the value chain	
Water & marine resources	Affected communities	
Biodiversity & ecosystems	Consumers & end-users	
Resource use and circular economy		

5. The first set of ESRS standards includes cross-cutting rules which apply to all in-scope firms, regardless of industry. Sector- and entity-specific rules are expected to be published separately, with the first 10 sector standards expected in Q2, 2023.

What's new?

There are a number of key shifts triggered by ESRS and CSRD that were not otherwise addressed in the NFRD.

DOUBLE MATERIALITY

The CSRD introduces the concept of 'double materiality'. This requires companies to report on financial materiality (how sustainability issues may translate to financial risks for the company) as well as impact materiality (the impact the company has on society and the environment).

Investors have always wanted to understand risks to their investments, climate-related or otherwise, but they are now becoming increasingly interested in how their investments impact people and the environment. This is largely driven by a growing demand for sustainable investment products, with investors themselves now required to report on the impact of their investment decisions under the EU's Sustainable Finance Disclosure Regulation.[6]

FORWARD-LOOKING REPORTS

Investors rely on forward-looking information in order to understand future prospects and emerging risks and, for this reason, forward-looking financial statements have been the industry norm for many years. The same cannot be said for sustainability-related data, however, and the NFRD has been criticized for failing to specify whether forward-looking information should be reported. The CSRD addresses this directly, requiring undertakings to disclose information regarding plans to limit exposure to climate-related risks moving forward.

The ESRS proposes that this information should:

1. Be based on conclusive scientific evidence where appropriate
2. Be harmonized, comparable, and based on uniform indicators where appropriate
3. Take into account short-, medium- and long-term time horizons and contain information about the organization's entire value chain

[6] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088

THE ENTIRE VALUE CHAIN

The CSRD requires in-scope firms to include information on the material impacts, risks, and opportunities connected to the entire value chain, including both upstream and downstream operations. Importantly, firms are asked to report on the value chain holistically and are not expected to share information pertaining to each and every entity.

Under certain circumstances, where the necessary information regarding the value chain is unavailable, organizations are expected to articulate the efforts made to obtain the information about its value chain, the reasons why it could not be accessed, and any plans to obtain such data in the future.

REPORTING ON INTANGIBLES

The NFRD does not require firms to disclose information relating to intangible resources[7] other than intangible assets recognized on the balance sheet (examples include intellectual property, brand recognition and reputation, relationships, and goodwill). However, certain information relating to intangible resources, particularly employee skills and welfare, relate directly to components of sustainability. The ESRS makes explicit reference to this, and as is the case throughout the rules, firms are asked to place equal focus on internal and external intangibles. Such data includes information about the quality of the relationships between the undertaking and its stakeholders, including customers, suppliers, and communities affected by the activities of the organization.

[7] For example, information about employees' skills, competences, experience, loyalty to the undertaking and motivation for improving processes, goods and services, is sustainability information regarding social matters that could also be considered as information on intangible resources.

THIRD PARTY ASSURANCE

Organizations reporting under the CSRD are to have their sustainability data verified by a neutral and trusted third party prior to disclosure. Although this "limited" assurance will be less stringent than financial audits, it still requires working closely with an independent sustainability reporting partner to validate the relevance and reliability of the information. This serves a number of benefits to interested parties:

- **Enhanced credibility:** External audits provide assurance to stakeholders that the sustainability disclosures are accurate, reliable, and free from material misstatements. This enables stakeholders to make informed decisions based on the information presented in the organization's reports.
- **Investor confidence:** External audits provide an additional layer of assurance to investors and other stakeholders, which can increase their confidence in the organization.
- **Improving internal controls:** External auditors may evaluate internal controls and associated data to make recommendations to improve their effectiveness going forward. This can help to prevent and detect errors and improve the robustness and standardization of corporate sustainability reporting in the long-term.

REPORTING FORMAT

Unlike NFRD, the CSRD requires sustainability related information to be "findable, comparable, and machine-readable". Member states may also require that in-scope firms make their management reports available on their websites, free of charge to the public. The digitalization of reports aims to promote opportunities to obtain and analyze information more effectively by centralizing data at a union and member state level, allowing for effective comparison.

The importance of compliance

While each EU member state will set specific penalties and define the limits of the sanctions within their respective jurisdictions, the European Commission (EC) has stated that they must be “effective, proportionate, and dissuasive.” Alongside financial penalties - which directly impact a firms’ bottom line - those breaching the obligations can also expect administrative sanctions such as:

- **Public denunciation:** Describing the breach and identifying guilty persons and/or entities. This, of course, carries much greater reputational risk which amplifies the duration and severity of initial regulatory sanctions
- **Order to change conduct:** This may involve unit or entity wide transformation, including potentially pausing or terminating contracts with third parties

DOUBLE MATERIALITY

The inclusion of double materiality promotes altruism throughout the private sector by making it mandatory to declare exactly how your organization is acting to align with European sustainability objectives. EU firms can have a positive or negative impact on society and the environment through their operations, resource consumption, waste disposal practices, and human labor conditions. The ESRS evolves previously voluntary initiatives into legally binding rules, ensuring that firms within the EU adapt their operations and governance structures to become a force for good. In doing so, the EC aims to create a virtuous cycle of sustainable development which not only benefits people and the environment, but also improves financial stability and reduces the climate-risks facing firms of the future.

How can technology facilitate a competitive advantage?

ESG AS A CORE STRATEGIC PILLAR

The introduction of CSRD reinforces the criticality of sustainability as a pivotal component of corporate strategy. Aside from compliance, a strong ESG performance enhances a company's reputation and brand value through demonstrating a commitment to sustainability and social responsibility. This can help to attract and retain customers and employees while boosting the value of the company in the eyes of investors. On average, companies with better ESG scores have delivered a higher total return to shareholders over the past decade, and according to research from Ipsos MORI, "more than 4 in 5 customers claim the ethical standards of retailers matter to them, with 38 percent willing spend more on a product if a company acts in an ethical way."

Robust sustainability reporting is notoriously difficult, however. Such disclosures require a detailed understanding of a range of complex and interrelated issues, such as human rights, environmental sustainability, social impact, and value chain operations, all of which are extremely hard to quantify. As a result, gathering and reporting on such ESG data can be time-consuming and costly for firms, especially smaller and mid-sized entities who were not subject to reporting requirements under the NFRD. Ensuring the accuracy and reliability of such data is therefore paramount, and firms cannot rely solely on third-party assurance to verify the data they are publicly reporting, particularly when we consider that ESG impact assessments require an ongoing process of data collection, analysis, and disclosure.

THE ROLE OF TECHNOLOGY

Technology can support firms in complying with the CSRD by automating data collection from multiple sources and integrating it into a central database. Not only does this reduce the resource burden of data acquisition, but it reduces human error and improves the accuracy of ESG disclosures. Such solutions enable leaders to track, assess, manage, and report on ESG risks and incorporate them within a broader risk Management strategy.

Innovative solutions, such as SAI360's Operational Risk Module, streamline the ESG data collection and analysis process to generate a 360-degree view of an organization's risk exposure. In doing so, managers can be confident that they are taking a data-led, holistic approach to climate-related risk Management while ensuring that they have a positive outward impact on society and the environment.

See what SAI360 has to offer

Regardless of where your company is on its ESG journey, SAI360's cloud-based platform can help you operationalize your strategy. Our modular approach allows you to take advantage of configurable solutions and quickly shape them to help you thrive in the evolving Governance, Risk and Compliance landscape. To learn more about SAI360 and how we can advance your GRC goals, contact us online to set up a call with one of our representatives.

About SAI360

SAI360 is the leading ESG cloud provider connecting GRC, EHS, Sustainability and Learning. Our SAI360 platform streamlines workflow and drives outcomes through flexible, scalable, and configurable modules. Our integrated approach sets us apart, helping organizations thrive, create trust, understand their impact, and achieve resilience for over 25 years. SAI360 is headquartered in Chicago, with operations and customers across the globe. Discover more at **sai360.com**.

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