INFORMATION FOR DIRECTORS AND SUPERVISORY BOARDS

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MANAGEMENTLTR

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SUSTAINABILITY REPORTING
for your company

CORPORATE SUSTAINABILITY REPORTING DIRECTIVE
Non-financial reporting

EU TAXONOMY
Focus on six environmental objectives

SUSTAINABILITY REPORTING

Sustainability is getting almost daily media attention. The coverage extends from the EU's aim to be climate-neutral by 2050, companies announcing their intention to reduce carbon emissions, and sustainability funds being set up as investment vehicles, to the public debate on whether nuclear energy and gas are green or not. But are you aware of the upcoming sustainability reporting obligations and their potential impacts for you and your company?

THE PROPOSED CORPORATE SUSTAINABILITY REPORTING DIRECTIVE (CSRD)

Many companies have not yet considered their future sustainability obligations in any depth. In April 2021 the EU published a proposal for a Corporate Sustainability Reporting Directive (CSRD) which would require all large corporations to publish regular reports on their environmental and social impact activities. Until now only 'public interest entities', meaning listed companies, banks, and insurance companies, with an annual average of more than 500 employees, were required to include non-financial disclosures in their management reports.

These non-financial disclosures must cover at least the following five dimensions:

- Environmental protection
- Social responsibility and treatment of employees
- Diversity on company boards
- Respect for human rights
- Anti-corruption and bribery

In the future the non-financial disclosure obligation will apply to a considerably larger number of companies. In fact, it will apply to all large corporations as defined in the German Commercial Code (HGB), not just public-interest entities, and the employee threshold has been lowered from more than 500 to more than 250. Even medium-sized groups with more than 250 employees that meet the criteria of section 293 HGB for large corporations will have a reporting obligation.

The non-financial disclosures will be included in the management report or the group management report and are subject to an external audit requirement. Since banks in particular have even more comprehensive reporting obligations, a ripple effect that is unrelated to the statutory obligations is also expected to impact SMEs and companies with other legal forms.

According to the proposal for a Corporate Sustainability Reporting Directive the scope of reporting will be extended to include all significant sustainability-related facts that provide an understanding of the company's business developments, position and financial results (outside-in perspective). Companies will also have to publish information that is necessary to understand their impact on society and the environment (inside-out perspective).

The sustainability reports will particularly focus on the following topics:

- Business model and corporate strategy, supplemented with information on their implementation in terms of sustainability criteria
- Sustainability policy
- Sustainability goals
- Extent of goal achievement
- Potential negative impacts of sustainability criteria on the company

The European Commission's proposal for a Corporate Sustainability Reporting Directive (CSRD) envisages the adoption of EU sustainability and ESG reporting standards tailored to European policies. They would be developed by the European Financial Reporting Advisory Group (EFRAG). According to the timeline, the first set of standards will be adopted via delegated act by the Europen Commission in October 2022.

The scope of action requirements in connection with ESG reporting could include the following:

Environment	Social	Governance
Climate protection	Diversity	Anti-corruption
Pollutant emissions	Equality of opportunities	Supplier code of conduct
Energy consumption	Respect for human rights	Whistleblower system
Resource efficiency (circular economy)	Health and safety	Standards of business ethics
Share of renewable energy	Social justice	Management board composition

EU TAXONOMY

The EU Taxonomy Regulation will become relevant because in future all companies affected by the Corporate Sustainability Reporting Directive (CSRD) will be required to comply with Article 8 of the Taxonomy and disclose information to the public on how and to what extent their activities are environmentally sustainable.

The Taxonomy has the following six environmental objectives:

- Climate change mitigation
- Climate change adaptation
- Sustainable use and protection of marine resources
- Transition to a circular economy
- Pollution prevention and control
- The protection and restoration of biodiversity and ecosystems

Technical screening criteria (TSC) established under the Taxonomy Regulation via delegated acts define when an activity is deemed sustainable. The TSCs for the first two environmental objectives have already been published as delegated acts, and delegated acts are currently being drafted for the other objectives.

For an economic activity to be deemed sustainable it has to meet the following three criteria:

- It must contribute substantially to one or more of the six environmental objectives.
- At the same time it must do no significant harm to any of the other environmental objectives.
- Also, it must be carried out in compliance with minimum social safeguards.

In particular, the proportion of turnover, capital expenditures (capex) and operational expenditures (opex) associated with activities included in the taxonomy must be disclosed.

Even though the CSRD will only affect large companies as defined in the German Commercial Code and groups with more than 250 employees, it is possible that these companies will demand CSRD compliance along their entire supply chains to ensure that their capex and opex are taxonomy-compliant. This could mean that smaller companies are also affected by the CSRD, even if they have no CSRD reporting obligations.

TIMEFRAME

According to the EU's timeframe, the CSRD will be applicable for the first time for fiscal years beginning on or after 1 January 2023. It isn't advisable to wait until the beginning of 2024 before implementing the CSRD (i.e. when preparing the management report for 2023). Firstly, a process will have to be set up to develop a strategy, establish a framework, define the goals and KPIs and measure the level of goal achievement. Secondly, it may be necessary before the first year of CSRD reporting to measure the extent to which the technical criteria are met (e.g. reduction of emissions).

The sustainability report itself is therefore the last step in a comprehensive process that has to be properly set up.

LEGISLATIVE PROCESS

Please remember that the CSRD is still only a proposal and significant amendments are possible in the next stages of the legislative process and the Directive's transposition into national legislation. Further details and delegated acts are expected in the course of 2022. Companies that will be affected by the CSRD are advised to keep up to date on the latest developments.

ARE YOU READY FOR SUSTAINABILITY REPORTING?

- ✓ Evaluate the importance of sustainability for the company
- ✓ Establish what stakeholder expectations are
- ✓ Define sustainability goals
- ✓ Align the sustainability goals with the business strategy
- ✓ Consider the sustainability goals' susceptibility to influence
- ✓ Identify and analyse risks
- ✓ Create a sustainability culture in your organisation
- ✓ Draft policies
- ✓ Define KPIs
- ✓ Establish a suitable reporting system

**IS THERE ANYTHING ELSE YOU'D LIKE TO KNOW?
YOU'RE VERY WELCOME TO GET IN CONTACT WITH US!**

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This is the second issue of our new series of Management Letters covering various aspects of the direct responsibilities of company directors, supervisory and advisory boards.

If you have any questions, we'll be happy to answer them or help you find an optimum solution.

You can download the previous issues from our website's News section.