Disclosure Briefing Series

Implementing the CSRD: Preparing for a New Era of ESG Disclosure

What the EU Directive means for companies and how they should prepare for it

The SustainAbility Institute by ERM

Contents

The SustainAbility Institute's Disclosure Briefing Series

This briefing by the SustainAbility Institute by ERM leverages knowledge from ERM's CSRD subject matter experts, utilizes resources developed by ERM Group company Sustainalize, and translates extensive topic research to develop an overview of the CSRD and guide companies in their disclosure journeys.

As ESG disclosure regulations and standards continue to be introduced across sectors and geographies, the SustainAbility Institute by ERM will continue this series of briefings to keep companies updated on crucial developments and give guidance on how to respond. This CSRD briefing is the second in this series and was preceded by a report on the Taskforce on Nature-related Financial Disclosures (TNFD). The Institute expects to publish a briefing on U.S. SEC's Climate-related Disclosure Rule in the second half of 2023.

Executive Summary

In the emerging ecosystem of ESG disclosure standards and regulations, the European Commission's Corporate Sustainability Reporting Directive (CSRD) is in a class of its own. It is the most ambitious attempt to date to put non-financial disclosures on an equal footing with financial disclosures, mandating companies to report in detail on their climate, nature, and social impacts. The CSRD is the next evolution of the ESG journey the European Union (EU) embarked on in 2014 when the Non-Financial Reporting Directive (NFRD) came into effect. Although in the same spirit as the NFRD, the CSRD is much broader in scope and more prescriptive, reflecting the EU's increasing appetite to set the sustainability bar high and create detailed regulations to enforce progress.*[1]

The CSRD bears all fingerprints of the EU's regulatory philosophy. Utilizing the European Sustainability Reporting Standards (ESRS), a framework developed as part of the CSRD, it demands detailed disclosures that companies will be held accountable to. The regulatory requirements will not be satisfied with only disclosing how ESG factors impact the financial well-being of companies; it also mandates information on how companies' behavior affects the well-being of the world.

In June of 2023, the CSRD released updated draft ESRS rules, implementing changes based on public comments and insights.[2] This updated version has received criticism from some observers for softening or eliminating some of the more influential and impactful requirements. But even with the latest version open for feedback until July of 2023, the updated CSRD rules and requirements are still sprawling and complex. To assist companies on their journey to compliance, we explore the essential takeaways from the CSRD, including the latest version of the ESRS framework, followed by recommendations on what steps companies can take to tackle the task ahead.

* Unless stated otherwise, technical information relating to the CSRD and NFRD was sourced from the European Union's published rules as listed in the first endnote.

CSRD TAKEAWAYS:

- **CSRD will leave its mark on companies well beyond the EU:** Many large companies with substantial business activity in Europe should prepare to comply with the CSRD's requirements. Around 50,000 companies are estimated to be subject to the Directive (up from 11,000 companies for its NFRD predecessor), including a number of non-European entities.[3] Furthermore, the CSRD will require these foreign companies to report on their entire scope of operations, not just activity in Europe.

- **CSRD turns impact assessment into a two-way street:** The CSRD is the first ESG disclosure law that makes double materiality mandatory. Companies will need to assess impacts from two directions: how sustainability topics impact the company's financial health and how the company's operations and upstream / downstream business relationships affect nature, climate, and communities around them.

- **CSRD is likely to set the direction of global regulatory trends on disclosure:** The CSRD is a groundbreaking EU directive that will likely influence sustainability disclosure trends worldwide. As such, even companies not subject to CSRD compliance will likely feel its influence indirectly through regulations CSRD is likely to inspire in other countries and the rising expectations of stakeholders such as organizations requesting information from their supply chain partners.

- **CSRD will continue to evolve:** Preparing for the CSRD will be a continuous process. The final ESRS sector-agnostic standards are expected in the second half of 2023, following a public comment period from June to July of 2023. The CSRD will be reviewed regularly as the regulation's timeline progresses and companies should expect updates to requirements and changes in compliance approaches, none of which are likely to lower the bar of what is expected of companies in their disclosures.

- **CSRD is just the beginning of sustainability-related disclosure:** The EU is set to continue adding further rules and raising the bar for companies on sustainability. With the creation of the EU Taxonomy's sustainable activity classification and the CSRD and its ESRS reporting framework, the EU has laid a solid foundation for mandatory ESG disclosure. Now it is preparing to move beyond: the European Parliament approved the Corporate Sustainability Due Diligence Directive (CSDDD) in 2023 and will require companies to address ESG challenges throughout their supply chain and report on improvement.[4]

Recommendations on how to prepare:

- **Start now to prepare for impending reporting requirements:** Reporting timelines vary for companies based on size and scope. But whether a company starts CSRD reporting in 2025 (with FY24 data) or later, none have the luxury to delay. It will take ample time to prepare internal systems for data collection and reporting according to the required standards. And for many companies that start CSRD reporting on FY24 data beginning in 2025, compliance requirements are just around the corner.

- **Consider all aspects of your disclosure process:** There are three primary components of the disclosure and reporting process that a company should consider: people, process, and technology. Stakeholder engagement is important to help a company understand all individuals impacted by the implementation of the CSRD. Processes will undoubtedly change with a company's approach to compliance, and any gaps that may hinder a company's compliance process should be identified. And upon disclosure, companies should utilize the many technological tools and resources available to ensure their disclosures are accurate, consistent, and easily accessible.

- **Conduct a readiness and disclosure gap assessment first:** The CSRD's details and requirements are complex, but EU regulators won't expect reporting to be perfect from the get-go. However, they will expect an honest attempt to make a good start, and conducting a gap assessment of a company's readiness to disclose is a great way to take that critical first step toward compliance. Transparency at this stage is important, and companies should disclose even if some processes and disclosures are incomplete or have yet to be implemented.

- **Follow a four-step process for efficient compliance:** Breaking down a company's compliance process can help with efficiency, accuracy, and accessibility of disclosed information. Following the four steps below will well position companies in their disclosure journey:

  Discover: Develop a comprehensive understanding of the company's position with respect to CSRD requirements, assessment gaps, material issues, etc.

  Design: Develop an approach to compliance and disclosure and translate into business outcomes, including effective communication and engagement strategies.

  Implement: Utilize technological resources and tools to build and execute communication and engagement plans, and integrate the CSRD into site level management systems.

  Report: Disclose information and conduct assurance requirements, audits, post-disclosure evaluations, and change adoption assessments.

- The EU has proven remarkably consistent in its desire to support its sustainability goals, as laid out in the Green Deal, with mandatory rules to move these goals forward. The CSRD fits right into this narrative. So, there' is only one thing to do for companies who want to keep doing business in the EU: get to work.

1. Setting the Stage: Getting Acquainted With the CSRD

Despite adding a new acronym to the ESG disclosure ecosystem, the CRSD is rooted in recent history. Most notably, it builds on the Non-Financial Reporting Directive (NFRD), which came into effect in 2014, marking a significant milestone in standardizing sustainability-related disclosure. In April 2021, the European Commission proposed the Corporate Sustainability Reporting Directive (CSRD) to replace the NFRD. The intent was to establish consistency in reporting methods and frameworks, enhance the availability and quality of non-financial data, and increase the flow of capital toward sustainable companies and activities. The CSRD was adopted in July 2022, and on January 5, 2023, the CSRD officially entered into force.

The introduction of the CSRD and its provisions mark an important step on the path towards globally consistent sustainability- and ESG-related regulation. The CSRD makes significant strides in this effort by promoting transparency, investor confidence, market efficiency, and global comparability. These factors are key for advancing sustainable development and fostering a more sustainable and responsible business environment globally.

Other important characteristics of the CSRD are its breadth and depth. The CSRD explicitly mandates detailed disclosures on companies' impact on nature and social factors, like human rights and labor conditions, while many other standards focus exclusively on climate. The CSRD requires companies to conduct a double materiality assessment, or the analysis of the impact that ESG factors have on a company's bottom-line and the impacts of their operations on climate, nature, and communities.

Although the CSRD is already in effect, companies still have several questions on its implementation. The EU itself is in the process of hammering out some important details like the European Sustainability Reporting Standards (ESRS), the framework that will outline the information and disclosure processes companies should follow to comply with the CSRD. Nevertheless, the EU has published enough information to answer three critical questions.

- **Who will be required to comply with the CSRD's requirements?**
- **How will companies ensure that they are in compliance with the CSRD?**
- **When will companies need to comply and report?**

In summary, the CSRD has four major objectives:

- **Encourage responsible approaches to business:** By implementing a requirement for companies to report in compliance with the European sustainability standards, the CSRD will encourage more sustainable and responsible business activities, which are needed to achieve the ambitious goals of the EU Green Deal;
- **Achieve greater transparency and comparability of non-financial disclosures:** Creating a standard by which companies will report on will ensure corporate sustainability information can be comparable and will improve the evaluation of non-financial performance;
- **Put sustainability reporting on par with financial reporting:** Raising the standards for sustainability reporting to that of financial reporting will help companies become more resilient and perform better, both in financial and non-financial terms; and
- **Align with broader legislative frameworks and, underlying political objectives:** By aligning with the broader legislative framework of the European Green Deal initiatives (e.g., EU Taxonomy Regulation), business can work collectively towards a common goal (for more context on the CSRD's alignment with broader legislation, see page 14).

1.1 Who Will Be Required to Comply With the CSRD's Requirements?

The CSRD makes a revolutionary leap in scope compared to the NFRD it replaces. Approximately 11,000 companies were subject to the NFRD; with the CSRD that number balloons to 50,000.[5] The Directive extends beyond European companies: any large corporates with a substantial European business must also comply with CSRD requirements.

The NFRD applied to large 'public interest entities' operating in Europe (i.e., companies with a balance sheet exceeding €20 million (~$22 million USD) or turnover exceeding €40 million (~$43 million USD)) with more than 500 employees, covering approximately 11,000 companies. The CSRD substantially widens this scope of coverage.

Even companies that are not covered by the CSRD are likely to feel its influence. Stakeholder demands, market pressure, and competitive practices will make it beneficial for many companies outside of the EU jurisdiction to voluntarily comply with the CSRD's guidelines. Companies should consider responses to the following questions to determine if they would benefit from voluntarily complying with the CSRD:

- Do any of your customers fall under the scope of CSRD and may demand CSRD-aligned data in the future?
- Are your stakeholders such as investors likely to require CSRD-aligned disclosure?
- Would the organization benefit from conducting a CSRD-aligned double materiality assessment?
- How can CSRD requirements help improve data collection and disclosure processes in your organization?

CSRD inclusion criteria for companies headquartered in the EU:

Companies with securities listed on regulated markets in the EU will be subject to the CSRD regardless of where they are headquartered (excluding 'micro-undertakings').*

Companies already subject to the NFRD will also be subject to the CSRD's requirements.

Companies that meet the EU's definition of a large undertaking will be subject to the CSRD.

Large undertakings are those that meet at least two of the following three criteria:

- The company has more than 250 employees
- The company's turnover exceeds €40 million
- The company's balance sheet exceeds a total of €20 million

CSRD inclusion criteria for companies headquartered outside of the EU:

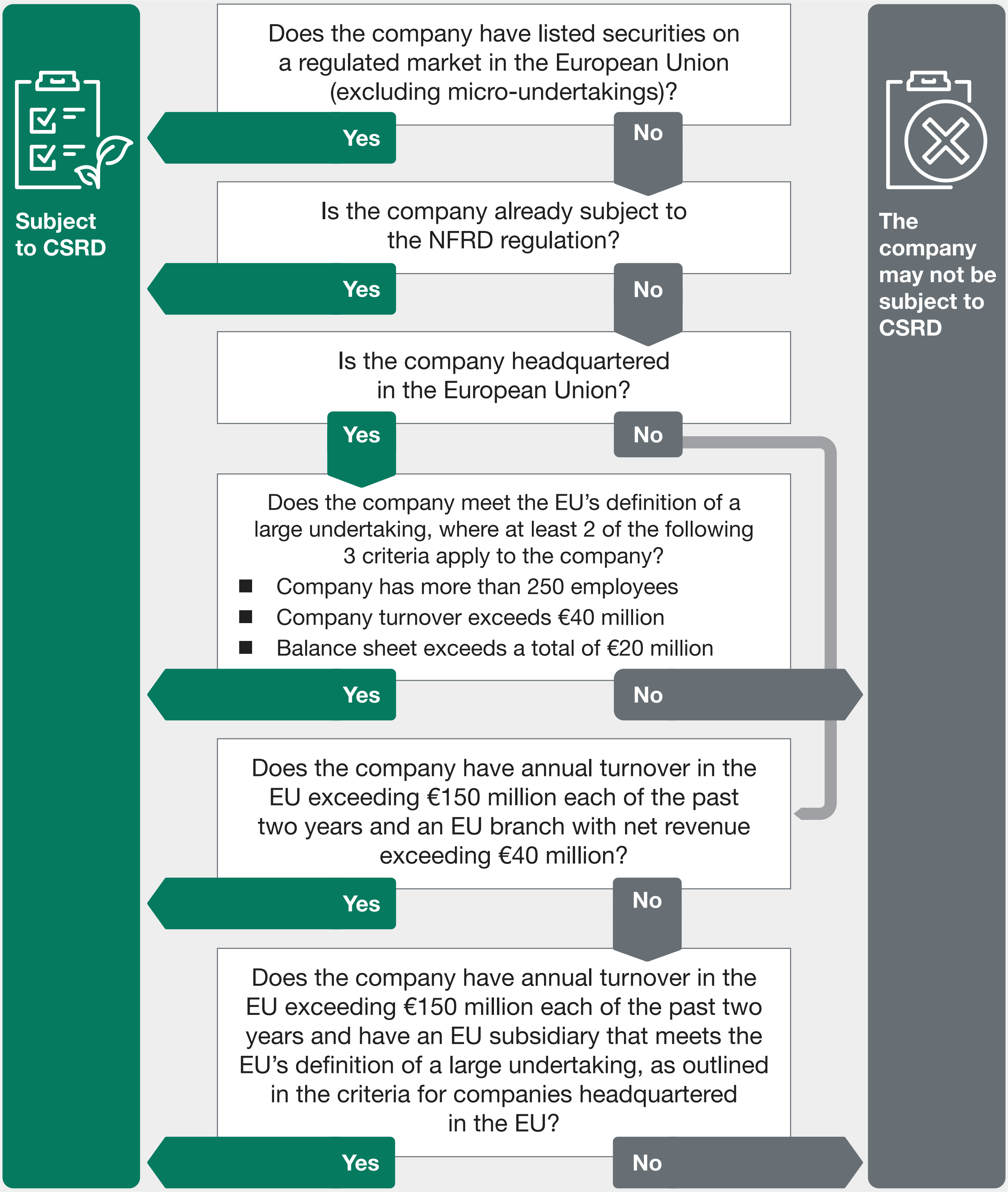
Companies with securities listed on regulated markets in the EU will be subject to the CSRD regardless of where they are headquartered (excluding 'micro-undertakings').

Companies headquartered outside of the EU operating in the region will be subject to the CSRD if the company has an annual turnover in the EU exceeding €150 million each of the past two years and either of the following applies:

- The company has an EU branch with net revenue exceeding €40 million; or,
- The company has an EU subsidiary that meets the EU's definition of a large undertaking, as outlined in the criteria for companies headquartered in the EU.

* Micro-undertakings are EU companies that do not exceed two of the following three limits: a balance sheet of €350,000, net turnover of €700,000, or 10 employees.

Figure 1:
Is your company subject to the CSRD?* **



* The CSRD implementation period began when the CSRD entered into force on January 5th, 2023. From this point, national legislators have 18 months to transpose the CSRD into national law.[6]

** As a directive under EU law, member states may put forward additional or more strict stipulations to define companies in scope of their national transposition of the CSRD.

Casting a wide net

Many large foreign companies won't be able to escape the reach of the CSRD's requirements. According to financial data firm Refinitiv, at least 10,000 companies outside of the EU will likely have to comply with the CSRD. Thirty-one percent of these are based in the United States.[7] Though only in-scope entities will have to report initially, parent companies will eventually be required to report on their entire scope of operations, not just those in the EU.

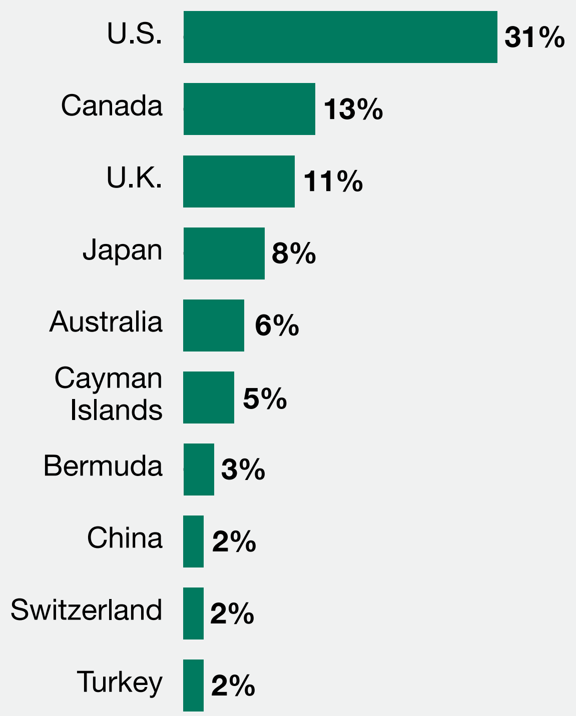
Even foreign companies that do not meet the CSRD's requirements are likely to feel its wide-reaching impact. As the CSRD requires extensive data collection and disclosure activities, compliance will require engagement with supply chain partners. As such, many companies that are not directly subject to the CSRD's requirements will likely receive inquiries and requests from business partners that are under the CSRD's jurisdiction.

The European Commission may allow companies complying with other standards to use those disclosures as an equivalent submission to the CSRD's requirements. However, any such equivalent standards have yet to be finalized and approved, and the CSRD's requirements are likely to remain more extensive than most. Because of this, it is unlikely that most other major rules such as the U.S. Securities and Exchange Commission's (SEC) Climate-related Disclosure Proposal will be eligible for an equivalent submission instead of ESRS disclosure deemed equivalent by the EU given its narrow focus on climate-related disclosures.[8] However, the CSRD has introduced increased interoperability with the International Sustainability Standards Board (ISSB), indicating a desire for more collaboration and cooperation across the major standards existing today.[9]

Still, companies that have already aligned their reporting with an established disclosure framework (e.g., GRI, TCFD, SASB, etc.) are likely to be at least partially prepared for the CSRD's implementation. The creators of many frameworks, standards, and regulations have worked together to ensure maximum alignment while still meeting individual disclosure needs.[10] The EU, for example, has partnered with GRI for the development of ESRS disclosure requirements.

Reporting Reach

Non-EU companies expected to be subjected to the EU's sustainability reporting rules, broken down by home country*



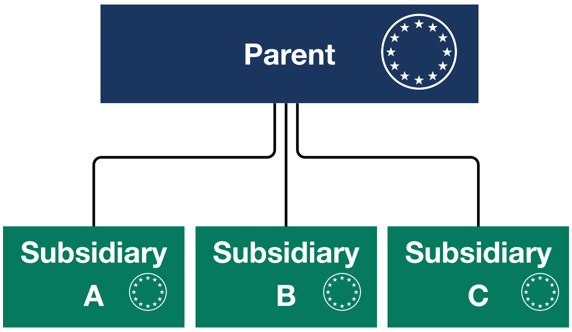
* Includes foreign companies with EU stock listings and those that have more than €150 million in local revenue. Excludes foreign companies bound by the rules due to other conditions.

Source: Refinitiv and the Wall Street Journal[11]

Figure 2:
Parent and subsidiary reporting obligations and timelines according to the CSRD*

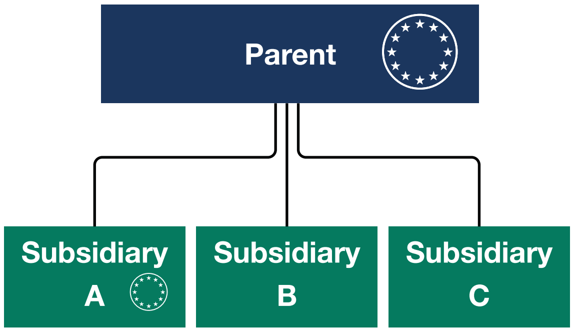
Example 1
EU HQ

All entities need to report; parent can report for subsidiaries



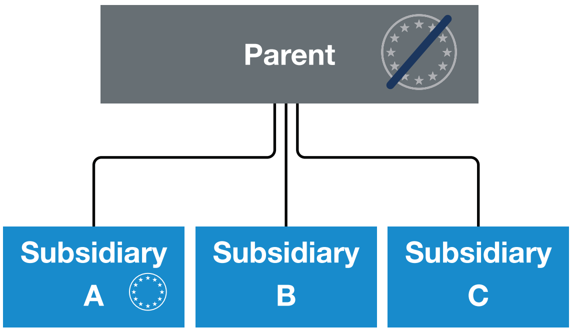
Example 2
EU HQ

Parent needs to report and must include all subsidiaries



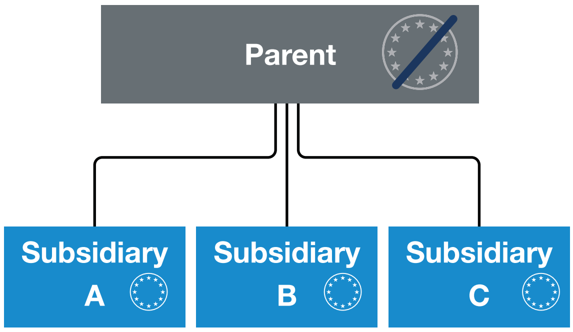
Example 3
Non-EU HQ

Only Subsidiary A needs to report initially, but group will have to report in 2029 on FY 2028 data



Example 4
Non-EU HQ

Subsidiaries will need to report initially, but group will have to report in 2029 on FY 2028 data



* Assuming all EU entities meet the criteria for required reporting.

1.2 How Will Companies Ensure That They Are in Compliance with the CSRD?

The CSRD enlists the ESRS to provide companies with detailed instructions on what information the EU requires and which disclosure processes they should follow to ensure compliance. In this two-pronged approach, the CSRD is the law telling companies what to disclose, while the ESRS is the framework that details how these disclosures should take shape.

The ESRS was first launched for public consultation in April 2022, later incorporating further updates based on feedback solicited from a variety of stakeholders. An updated draft was then submitted to the European Commission in November 2022. Following an additional round of public feedback beginning in June 2023, the first components of the ESRS are likely to be adopted in the second half of 2023. Further in-depth guidance and sector-specific standards are expected to be adopted shortly thereafter. Together the CSRD and ESRS will determine how companies report, relying on several key components and requirements:

- **Double Materiality:** The ESRS disclosure frameworks are based on the double materiality principle to ensure that companies are only reporting against topics that are relevant to their organization and value chain.[11] Companies will need to identify the impacts, risks, and opportunities associated with different sustainability topics and prioritize these based on their severity. Sustainability topics that are determined to be material from either an impact or financial materiality perspective will need to be disclosed under the ESRS. See page 21 for further information on impact and financial materiality.

- **Value Chain Assessment:** Companies subject to CSRD requirements will have to collect data on their value chain partners, both upstream and downstream, to report on relevant material impacts, risks, and opportunities. Because of this requirement, companies that are subject to CSRD requirements are likely to start sending significant data requests to other businesses within their value chain requesting relevant information, extending the reach of the CSRD's requirements outside of its immediate jurisdiction.

- **Reporting Consolidation and Format:** To elevate sustainability-related information to the level of financial disclosures, the CSRD requires companies to disclose information within their management report alongside financial disclosures, using a digital, machine-readable format.* This is likely to significantly impact reporting timelines for some companies, as reports may require shorter timelines than previously, and data will need to be available even sooner after the fiscal year ends.

- **Alignment to Other Legislation:** Several pieces of legislation in the EU are closely tied to the CSRD, and companies subject to its requirements should consider the requirements of these regulations (see page 14). Other relevant legislation includes the EU Taxonomy, Sustainable Finance Disclosure Regulation (SFDR), and the Corporate Sustainability Due Diligence Directive (CSDDD).

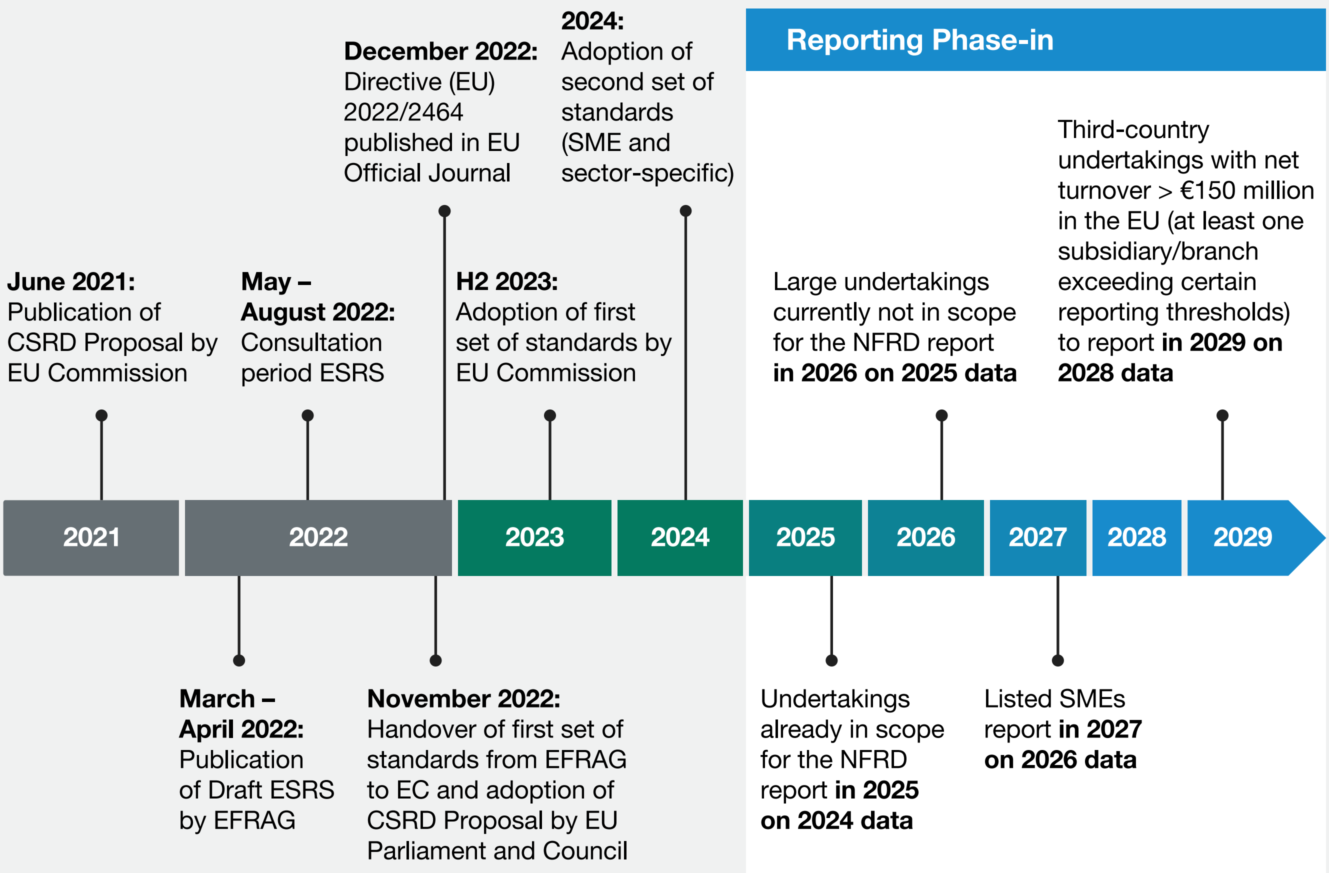
* The management report is an annual company report produced in compliance with EU requirements including information such as developments of importance, likely future developments, R&D activities, equity information, etc. All information required by the CSRD is to be disclosed in a company's management report.

- **Assurance:** The CSRD puts forward a progressive assurance requirement, gradually phasing in rather than making requirements immediate. The progressive requirements begin with an obligation for companies to receive limited assurance of reported sustainability information from an external provider. The European Commission has included an option to move towards reasonable assurance as the Directive’s timeline progresses, with potential adoption of reasonable assurance standards beginning for certain companies in 2028.[12]

1.3 When Will Companies Need to Comply and Report?

Companies currently subject to the NFRD will need to comply with CSRD requirements in 2025 for financial year 2024, with others required to comply along a graduated timeline between 2025 and 2029 depending on their location, size, and scope of operations (see Figure 3). In addition, progressive timelines for certain requirements such as assurance allow for incremental changes and updates.

Figure 3:
Around the corner – CSRD regulatory timeline



1.4 How Does the CSRD Fit Into the Wider Disclosure Landscape?

The CSRD exists in a crowded sustainability- and ESG-related regulation landscape. Entities across the globe are recognizing the need for disclosure on ESG topics and are likely to be taking direction from the EU in drafting proposed regulations. Because of this, the CSRD is intricately connected to many different disclosure regulations across geographies.

The CSRD is a product of the EU's decades-long effort to build a sustainable disclosure ecosystem and interacts with other legislation that was created to that effect. Three major pieces of legislation in the EU have strong links with the CSRD:

EU Taxonomy[13]

Published in June 2020, the EU Taxonomy established a classification system to create a common language for sustainable finance and corporate sustainability. Its purpose is to ensure investors have enough information to compare sustainability disclosure and performance across different companies. The Taxonomy provides the qualification criteria of sustainable economic activities, which can then be applied to determine which information to include in CSRD-aligned disclosures. In short, the Taxonomy helps companies and investors identify sustainable economic activities while the CSRD (and SFDR) provide a framework and guidelines to report on those activities. Taxonomy reporting is mandatory for those companies subject to the CSRD's requirements and covers the main revenue generating activities as well as capital expenditure.

SFDR[14]

The Sustainable Finance Disclosure Regulation (SFDR) requires financial market participants and financial advisors to disclose sustainability-related information within their operations and portfolios. It also prescribes classification of financial products (funds, bonds, etc.). Financial market participants include pension funds, banks, private equity firms, insurance companies, etc., while financial advisors include those individuals, entities, or intermediaries that guide consumers on insurance, investment, and pension products.[15] Companies within the portfolio of an organization subject to SFDR are likely to have to report information to their investors. Like the CSRD, the SFDR uses EU Taxonomy's definitions for sustainable economic activity.

CSDDD[16]

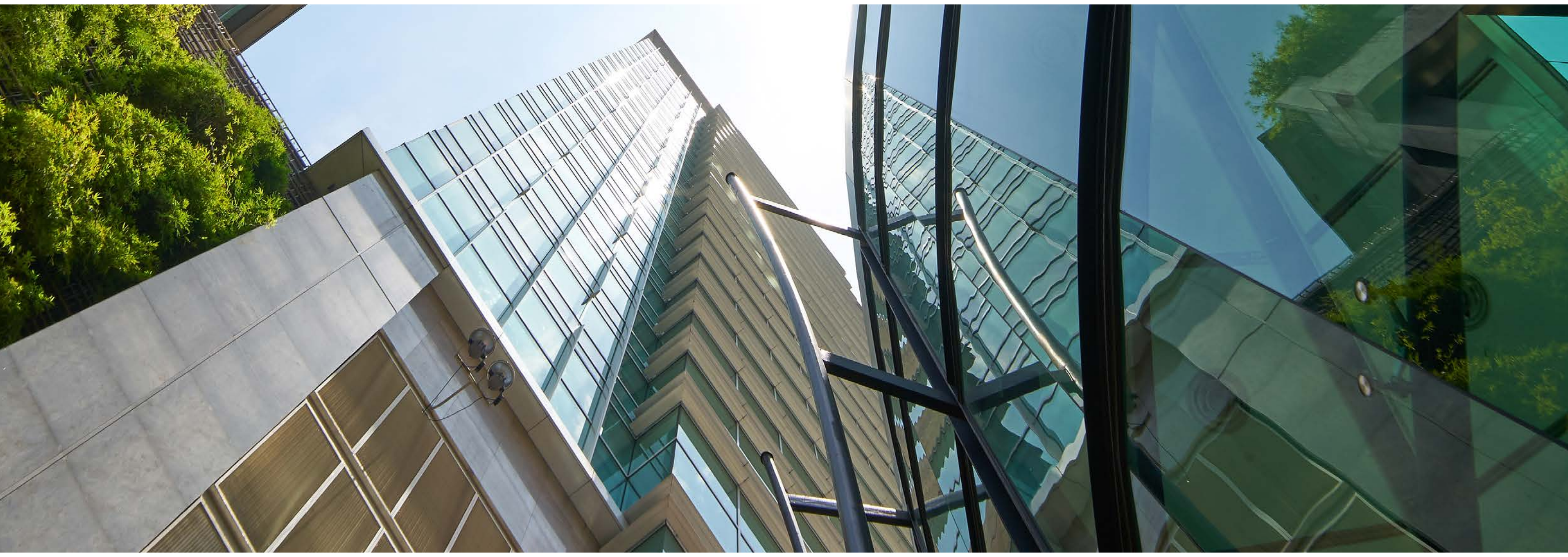
The Corporate Sustainability Due Diligence Directive (CSDDD) was adopted in February 2022 and was passed by the European Parliament in June 2023 (as of publication of this report the full regulation has not been fully adopted and is not yet in force). The CSDDD focuses on human rights and environmental impacts within a company's supply chain and aims to "foster sustainable and responsible corporate behavior in companies' activities and governance structures." It is intended to work in tandem with the CSRD as the primary reporting method for companies to disclose sustainability-related activities throughout their supply chains.

Of course, the EU is not alone. Many other jurisdictions and organizations have introduced their own sustainability-related disclosure proposals, often integrating work from similar regulations and frameworks. In that sense, many regulations, standards, and frameworks in the ESG disclosure space have some overlap or common roots.

Two prominent disclosure proposals companies should be aware of are the SEC's Climate-related Disclosure Proposal in the U.S. and the International Sustainability Standards Board's (ISSB) General and Climate-related Disclosure drafts. While each is unique in its own right, the CSRD, SEC, and ISSB all align with a global movement towards consolidated and consistent disclosure of ESG-related information.

Specifically, the three closely adhere to the Taskforce on Climate Financial Disclosure (TCFD) framework, use the Greenhouse Gas Protocol's Corporate Accounting and Reporting Standard, and incorporate disclosure requirements for at least Scope 1 and 2 emissions.*

Despite these overlaps, the CSRD's links with other EU legislation is far more comprehensive and detailed than its ties with disclosure frameworks and requirements outside of the EU. Companies subject to other regulations or proposals may benefit from this when preparing for CSRD compliance, but they will likely still need to take substantial action to fully comply.



* At the time of report development, SEC and ISSB frameworks had not been finalized. Components of each are subject to change.

Figure 4:
Diverse landscape of ESG reporting regulations and frameworks

Framework	Jurisdiction	Focus	Key Components and Functions	Status	Mandatory / Voluntary
CSRD[17]	European Union	Corporate Sustainability	Double materiality assessments determine the information to be reported through the ESRS reporting framework.	In force as of January 2023.	Mandatory Regulation
SFDR[18]	European Union	Sustainable Finance	Entity- and product-level disclosures of sustainability-related risk in investment decision making.	In force as of January 2022.	Mandatory Regulation
CSDDD[19]	European Union	Sustainable Supply Chains	Establishment of a framework for responsible supply chains, requiring companies to report on environmental and social impacts of their own operations and that of their suppliers.	Approved by the European Parliament in June of 2023.	Mandatory Regulation
EU Taxonomy[20]	European Union	Sustainable Business Activities	Classification of sustainable activity; disclosures are required under the CSRD and SFDR regulations.	In force as of July 2020.	Mandatory Regulation
SEC Climate Disclosures[21]	United States	Climate Risk Disclosure	Integration of TCFD and GHG protocol.	Proposal stage with final rule anticipated in 2023.	Mandatory Regulation
ISSB[22]	Guidance framework, no jurisdiction	Corporate Sustainability	Comprehensive baseline of sustainability disclosure standards that can be mandated and combined with jurisdiction-specific requirements.[23]	Partially complete with an effective date of January 2024. Additional components in development.	Voluntary Framework (can be used as guide for mandatory regulation)

2. Establishing Targeted Disclosure: A Deep Dive into the Provisions of the CSRD

The CSRD significantly elevates the bar for sustainability-related activity and disclosure, introducing several new or updated requirements. This section provides an overview of three important CSRD provisions: the revision of the NFRD, the creation of the ESRS framework, and guidance on double materiality assessments. These selected provisions are by no means the only important considerations but have the highest immediate relevance for companies on their path to compliance.

2.1 Deep Dive: Revision of the NFRD

Adopted in 2014, the NFRD requires companies within scope to include non-financial disclosures in their annual reports. The Directive includes dimensions such as environmental protections, social responsibility, human rights, and diversity. Information must be included in the annual report or disclosed in a separate sustainability report with clear reference to it in financial and management reports (i.e., annual reports).

The NFRD provided an early foundation for both regulators and companies on how non-financial information should be disclosed. But even though similar in spirit, the way NFRD was implemented in EU member states varied widely, which stipulated the need for a common reporting standard to increase comparability.

When the CSRD entered into force in January 2023, it effectively replaced the NFRD. While they have many similar components, the CSRD significantly expands the scope of covered companies and increases the data disclosure requirements, while creating a common and consistent reporting standard.

Figure 5:
Upgrading from the NFRD to the CSRD

Component	NFRD	CSRD	Bottom Line
Scope	Large 'public interest entities' with more than 500 employees including listed companies and banks & insurance companies.	All large EU-based companies meeting 2 of the 3 disclosure criteria and all companies listed on EU regulated markets. Some foreign-based companies with activity in the EU are also subject to CSRD requirements (see section 1.1 for further details).	Nearly 40,000 more companies are required to comply to the CSRD than were covered by the NFRD.[24]
Reporting Requirements	Companies must report on topics such as environment, social responsibility, diversity, etc. across the four dimensions of policy, outcomes of policy, risks, and KPIs.	Companies must report in alignment with the cross-cutting standards and the E, S, and G sector-agnostic standards (sector specific standards have not yet been published but will be required).	While disclosure will be more detailed, it will also be more structured.
Reporting Outputs	Information must be included in the annual report. A sustainability report can be disclosed separately as long as it is clearly referenced in the financial and management reports.	Information must be included in the management report as a digital, machine-readable output.	Information will be more accessible by analysts and AI.
Assurance	Not mandatory in most countries, and auditors should only check that a non-financial statement or separate report has been developed.	Limited assurance is required, with the expectation of moving to reasonable assurance.	Assurance is now required, and companies should prepare for reasonable assurance of data.

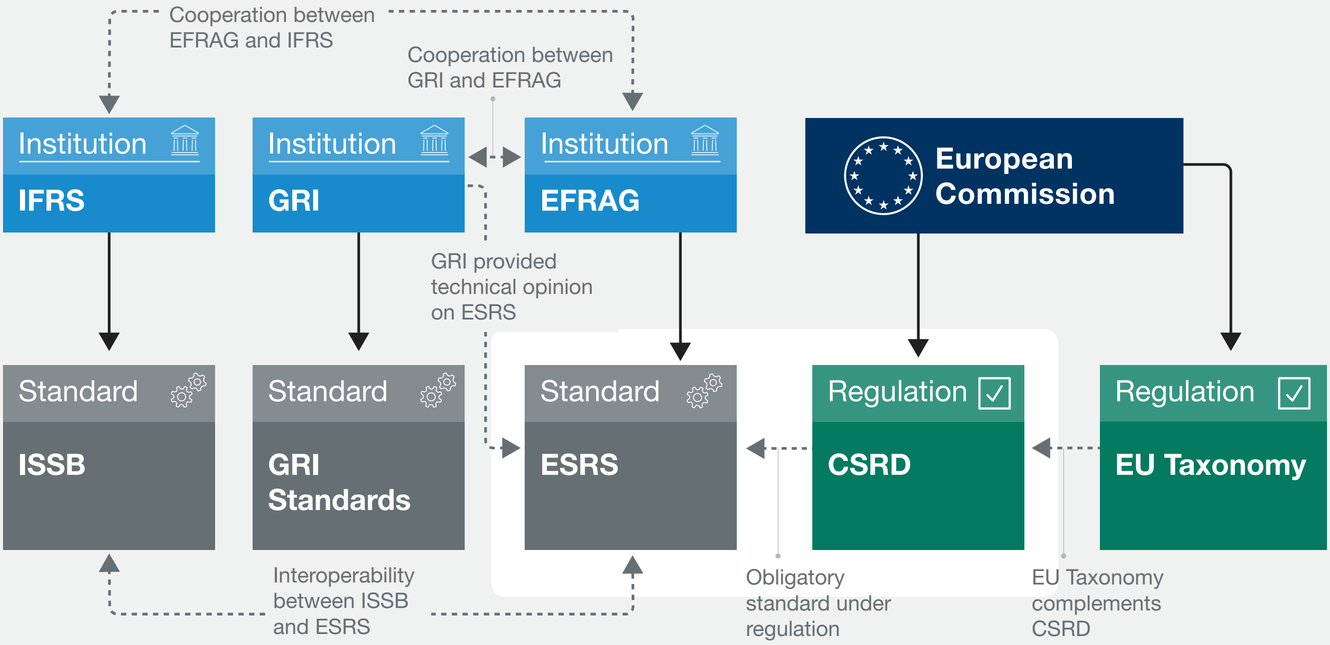
2.2 Deep Dive: The ESRS Framework

While the CSRD is the law that companies are required to comply with, the ESRS framework, drafted by the European Financial Reporting Advisory Group (EFRAG), instructs companies on how to report in compliance with the CSRD. After public consultation and an additional review process between June and July 2023, the European Council and Parliament are expected to approve the final standards in the second half of 2023. Sector-specific standards will follow sometime in 2024. The ESRS framework is intended to standardize ESG reporting in all EU member states and allow for more accurate, consistent, and comparable data on ESG-related topics.

The disclosure framework breaks down ESG issues into four sections: cross-cutting standards, environment, social, and governance. Each of these sections are split into three layers of reporting:

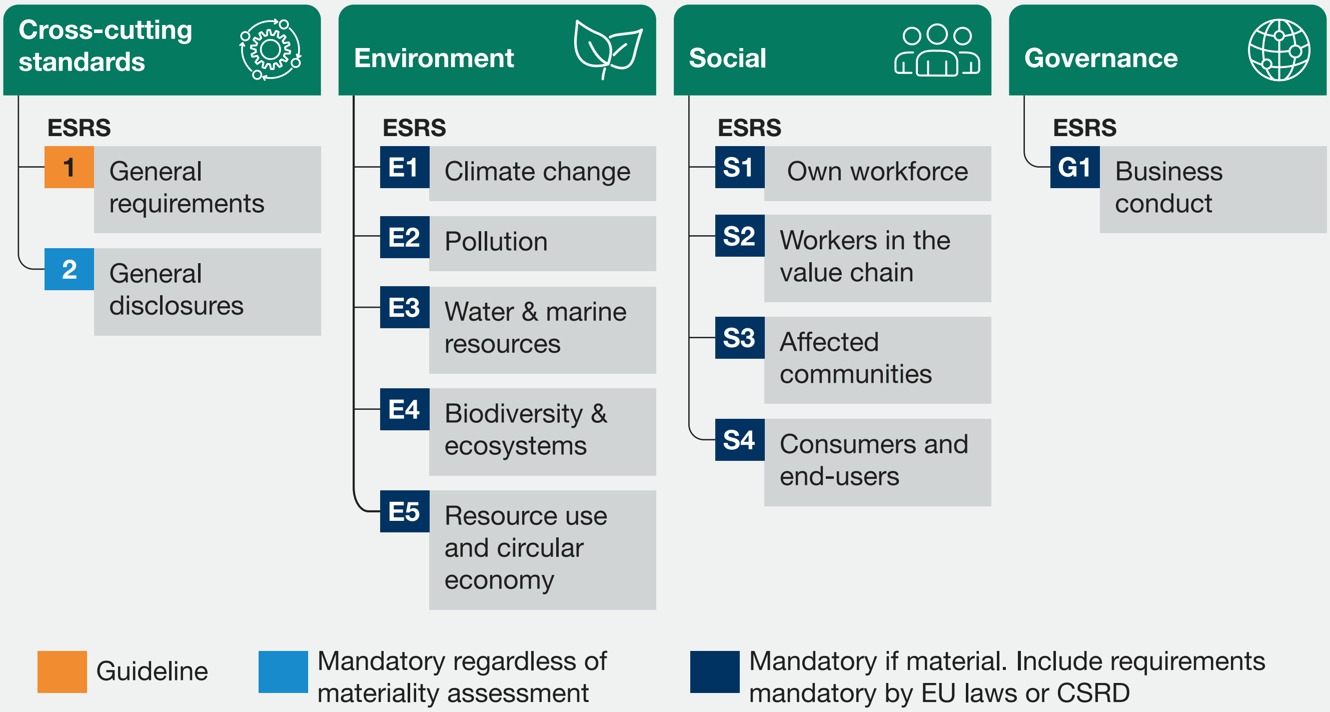
- Sector-agnostic: applicable to all companies, allowing for comparability across sectors
- Sector-specific: detailed requirements by sector for sector-specific comparison (not yet released)
- Entity-specific: entity-specific information on risks & opportunities or materiality, when necessary (not yet available)

Figure 6:
How the EU ESG regulation and reporting ecosystem fits together[25]



Source: Latest updates on the CSRD – Sustainalize[26]

Figure 7:
Four pillars of the ESRS[27]



*Reporting areas for some topical standards are still in development at the time of this report's publication in June 2023.

The disclosure requirements within the ESRS include the following reporting areas within each topical standard, as defined by the ESRS:

- **Governance:** the governance processes, controls and procedures used to monitor and manage impacts, risks, and opportunities;
- **Strategy:** how the undertaking's strategy and business models interact with its material impacts, risks and opportunities, including the strategy for addressing them;
- **Impact, risk and opportunity management:** the processes by which impacts, risks and opportunities are identified, assessed and managed through policies and actions;
- **Metrics and targets:** how the undertaking measures its performance, including progress towards the targets it has set.

Reports will need to be published in XHTML format as required by the European Single Electronic Format (ESEF) regulations and EU sustainability taxonomy, along with digitally tagged sustainability information. This will allow for easier access to information and accurate extraction of data from reports. Upon completion of data collection, companies will be required to receive limited assurance on their disclosures from a third party. The European Commission has also included a provision that could require reasonable assurance after implementation of the rule.

The era of more accurate, consistent, and comparable ESG data that the ESRS framework is meant to introduce, has been accomplished in part by aligning with existing disclosure standards and frameworks. In development of the ESRS, EFRAG established a formal collaboration with the Global Reporting Initiative (GRI) to incorporate GRI processes into the ESRS disclosure requirements. ESRS has also outlined limited interoperability with the TCFD and the ISSB, establishing consistency with major frameworks used across geographies and sectors.[28]

2.3 Deep Dive: Double Materiality

The CSRD's introduction of a double materiality assessment is another seismic shift. Traditionally, the emphasis of company financial reporting is on the impact of external events on the company's financial health. The CSRD utilizes a two-way approach, requiring companies to conduct a double materiality assessment. Companies are required to identify and assess the severity of material impacts they have on society and the environment in addition to the risks and opportunities that ESG issues present to the company and its value chain.

A company must report against the ESRS standards it determines to be material from either an impact or financial materiality perspective. The assessment of positive and negative impacts on the environment and society allows a company to determine which ESRS standards require reporting based on an impact materiality perspective, while the assessment of risks and opportunities determines the topics relevant from a financial materiality perspective. A step-by step guide on how to conduct a double materiality assessment can be found in the subsequent section.

Figure 8:
Comparing financial and impact materiality

Component	Financial Materiality	Impact Materiality
Definition	Financial materiality considers those risks and opportunities that may financially impact a company's operations.	Impact materiality considers both positive and negative impacts that a company's business activities may have on the environment or society at large.
Measurement	■ Likelihood of occurrence ■ Size of potential financial effects	■ Severity of impact ■ Likelihood of impacts ■ In the case of a potential human rights impact, the severity of the impact takes precedence over its likelihood.
Assessment Requirements	Actual or potential risks and opportunities	Actual or potential positive and negative impacts
Time Horizon	Short-, medium-, and long-term	Short-, medium-, and long-term
Influence	Influence on internal factors such as cash flows, development, performance, position, cost of capital or access to finance	Influence on external factors such as environmental or societal issues like climate change, biodiversity, or health impacts.

The CSRD offers comprehensive guidance on the concept of double materiality and introduces several specific requirements:

- **Impact prioritization:** Companies are required to develop and evaluate a list of positive & negative impacts they have on society and the environment by assessing their severity and likelihood. The determination of an impact's severity should be based on its scale, scope, and irremediable character. In the case of a potential negative human rights impact, the severity of the impact takes precedence over its likelihood.

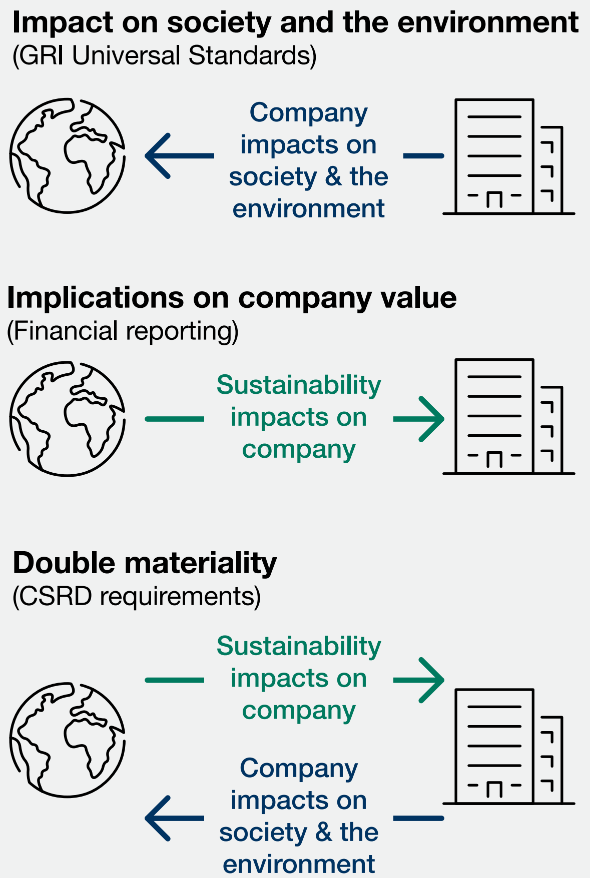
- **Risk & opportunity prioritization:** Companies are also required to develop and prioritize a list of ESG-related enterprise risks & opportunities based on their potential to trigger material financial effects on the company. This must be considered over a short, medium, and long-term time horizon. Organizations should engage with their risk functions to ensure that the assessment aligns with the company's existing enterprise risk management approach.

- **Disaggregation:** Companies must provide disaggregated information by country, subsidiary, and/or significant site, if presenting information at a higher level of aggregation would obscure material information. For companies based outside of the EU, this will eventually mean reporting on the entire scope of their operations, not just those in Europe.

- **Value chain mapping:** The impacts, risks, and opportunities identified and prioritized by companies must be inclusive of their direct and indirect business relationships in their upstream and/or downstream value chain.

Overall, an ESRS-aligned double materiality assessment process will require mapping and prioritizing a broad range of actual and potential impacts, risks, and opportunities. The requirement to identify and prioritize specific impacts, risks, and opportunities set out within the ESRS will be a step forward, even for those companies that have conducted similar assessments in the past. However, setting up a robust, effective methodology that can be updated on a regular basis will provide value to organizations beyond meeting the disclosure requirements of the CSRD. Armed with a comprehensive understanding of impacts, risks, and opportunities, organizations will be well-equipped to develop strategies to manage them effectively.

Figure 9:
The two-way street of double materiality



3. Preparing for Regulation: Guidance on how to Prepare for Implementing the CSRD

3.1 Core Pillars of Company Response

The CSRD, in tandem with its ESRS framework, is a sprawling, comprehensive piece of legislation that will ask much from companies to adequately prepare. Companies subject to compliance should roll up their sleeves as soon as possible, no matter what year they need to begin reporting according to the CSRD. Complying with the CSRD will require fundamentally reimagining how companies gather and report data, but it is also important that companies do not just view it as an exercise focused on process and governance. To effectively comply with the Directive – and also deliver benefits to the business – companies should consider the following three dimensions in their response:

People: Complying with the CSRD is first and foremost a change management exercise that should put people at its center. Within this journey, an organization should start by aligning leadership on the specific goals and overall change vision of implementing the CSRD. Stakeholder mapping and analysis will support a better understanding of all the individuals that will be impacted by the change and aid the development of a communications and engagement plan. It is key that this plan is tailored to where these individuals are within their change journey. People and their willingness to change together with their level of influence to change, is the key to the successful implementation of CSRD. Thus, stakeholder engagement is the golden thread throughout all stages.

Processes & Governance: Clear guidelines for data collection, handling, and vetting will be critical for reliable disclosure in alignment with the CSRD. Building consistency across an enterprise's governance processes can help an organization move its focus from the collection of data and information to developing actionable insights. These insights can then be leveraged in a company's journey to move from check-the-box compliance to integrating ESG and sustainability into everyday activities and overall strategy. These processes and governance steps are an essential part of connecting disclosure and compliance to long-lasting action.

Technology: Lastly, technological tools and software systems enable accurate measurement, tracking, and reporting of the information required by the CSRD. Through this, companies can streamline and automate data to identify efficiency improvements, opportunities for value creation, and potential sustainability-related risks. And upon disclosure, companies should utilize the many technological tools and resources available to ensure their disclosures are accurate, consistent, and easily accessible.

3.2 Four Stages of CSRD Compliance: Discover, Design, Implement, and Report

When using People, Processes & Governance, and Technology as the foundational pillars of their response, companies should consider approaching CSRD compliance in four stages.

The Discover phase should focus on familiarizing the key stakeholders with the CSRD requirements, identifying and prioritizing materiality topics, and identifying gaps in existing processes, programs, and disclosures.

The objective of the Design phase is to develop an implementation roadmap that translates the insights from the first phase into a bespoke actionable plan. The roadmap should specify the timelines, key stakeholders and actions that will help to get the organization ready for the Implementation stage.

Most organizations are currently in the Discover and Design phases. Thereafter, the focus shifts to implementing the recommended roadmap and the related change and transformation activities. These transformation activities are likely to take place after disclosure is completed and can help a company fully integrate the CSRD's requirements into its strategy and operations beyond just the disclosure of information.

Figure 10:
Four steps towards CSRD compliance

Discover
- CSRD awareness engagements and training
- Develop stakeholder analysis & needs assessment
- Leadership alignment
- Asset mapping
- Double materiality
- Gap assessment

Design
- Develop bespoke approach
- Translate approach into business outcomes
- Assess and recommend operationalization journey
- Communication and engagement strategy and planning

Implement
- Technology selecton
- Digital rollout
- Build and execute communication and engagement plans

Report
- Pre-assurance
- Disaggregated reporting
- Corporate reporting
- Audit & evaluation
- Change adoption assessment and reinforcement activities

3.3 Emerging Best Practices

Taking the first steps towards the new CSRD requirements might prove to be overwhelming and somewhat confusing for organizations. Companies are only starting the process of identifying their CSRD compliance timelines and first steps, while methodologies and best practices are only beginning to emerge and will evolve over time. Below we outline some initial guidance and ERM's thinking on what steps to prioritize and how to go about them.

3.3.1 Double Materiality Assessment

Conducting a double materiality assessment is one of the core steps on the way to compliance with the CSRD. To meet the double materiality requirements of the ESRS, companies will need to identify and prioritize a range of sustainability impacts, risks, and opportunities. This identification and prioritization should also include an appropriate level of engagement with internal and external stakeholders. Results of the assessment should then be validated by the organization's leadership to ensure that they can be effectively integrated into the organization's strategy.

Having completed the double materiality assessment, the organization will have identified its material topics – the topics it will have to report on under the CSRD. Findings will be used to map results to disclosures and will serve as the prerequisite for a detailed CSRD gap assessment.

Double Materiality in Three Steps

1 Identifying enterprise level impacts, risks, and opportunities

Current State Assessment: Review the organization's current state and external context to build an initial list of priority ESG topics and associated impacts, risks, and opportunities that reflects current and future trends and priorities. As part of this process, the organization's value chain should be mapped and validated with internal stakeholders.

Stakeholder Engagement and Information Gathering: Engage internal and external stakeholders to identify specific positive & negative impacts and risks & opportunities associated with the organization's ESG topics. Review additional sources of information (such as big data sources, company data, and external research) to supplement stakeholder perspectives. Consolidate the impacts, risks, and opportunities identified per material topic.

2 Prioritizing enterprise level impacts, risks, and opportunities

Impact and Risk/Opportunity Severity Review: Determine the severity of the potential and actual impacts, risks, and opportunities associated with the identified material topics.

Topic Prioritization: Assess, evaluate, and visualize the relative significance of the material topics based on their impacts, risks, and opportunities to determine strategic and reporting priorities.

Validation: Validate materiality assessment results with executives, board members, and/or other company leaders.

3 Supplementary analysis of significant locations, assets, sites, and/or subsidiaries

Assess country, site, asset, and/or subsidiaries: Review if countries, sites, or assets are sufficiently dissimilar that they may have specific impacts, risks, and opportunities that require disaggregated reporting.

Additional stakeholder engagement and source evaluation: Conduct additional stakeholder engagement and research if any countries, sites, assets, and/or subsidiaries require assessment of any additional impacts, risks, and opportunities based on the review.

3.3.2 Assessing the Gaps

After identifying ESG material topics, conducting a readiness and disclosure gap assessment will help identify gaps in the organization's alignment with the CSRD's general requirements and the topic-specific requirements of the ESRS.

A gap assessment should evaluate current disclosures, internal availability of data where data is not disclosed, processes, and procedures to collect relevant data, and data collection solutions such as digital systems. As a result, the assessment should provide the organization with an overview of where CSRD general and topic-specific requirements are already met and where the organization is falling short. As the implementation of processes and systems may take a significant amount of time, companies should conduct the CSRD gap assessment well in advance of their first mandatory reporting year.

It is important to note that CSRD not only covers quantitative KPIs but also requirements for policies, processes, and controls. The gap assessment should also focus on the actual governance systems a company has in place. In short, the companies should look at the key aspects of their business through the lens of the CSRD.

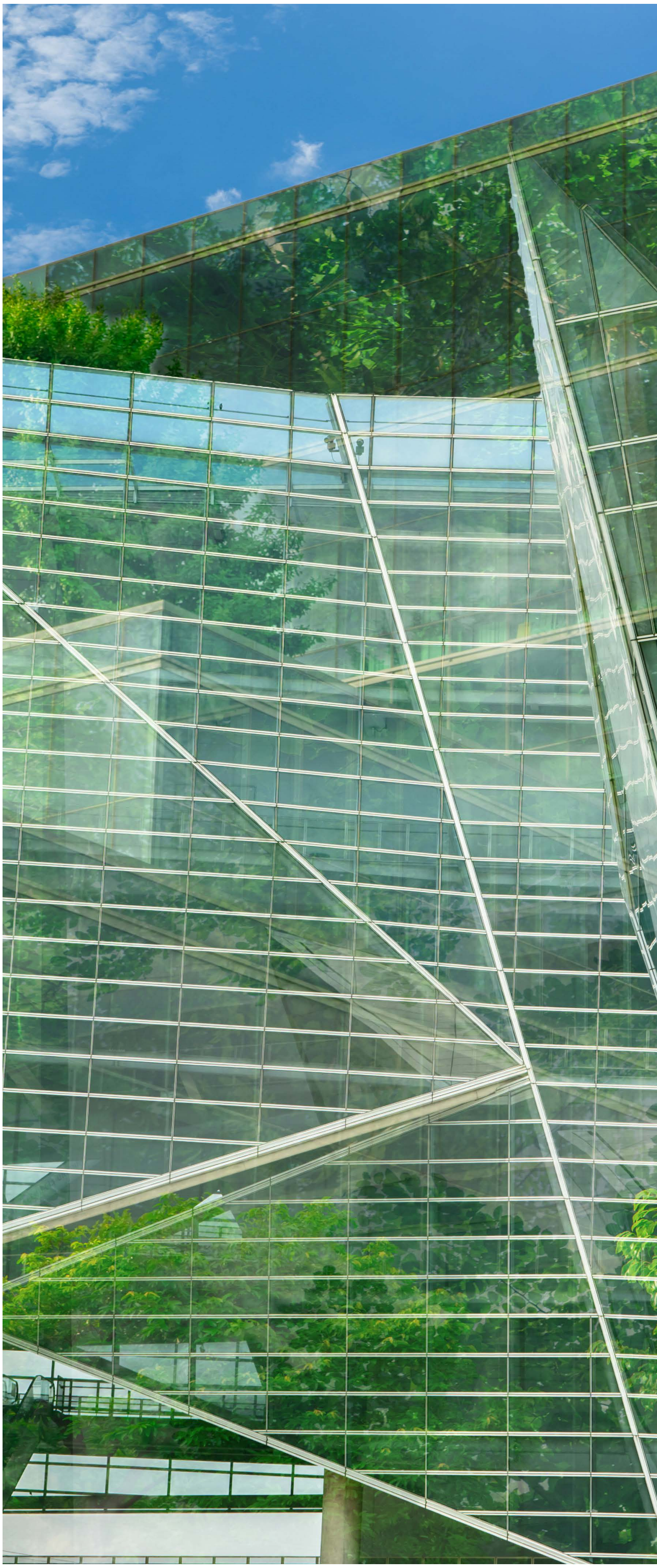
3.3.3 Operations at the Heart of Complying with the CSRD

Complying with the CSRD will require collecting, processing, and reporting ESG data at a scale and level of accuracy that companies have not experienced before. Reimagining and redeploying foundational Sustainability and Environmental Health & Safety (EHS) programs already in place and taking a holistic approach to sustainable operations will be key. While CSRD is one of the main drivers forcing companies to take a second look at their data collection and processing systems, they are facing pressure for more reliable and comprehensive data from multiple other sources as well, such as investors, lenders, and a growing number of other regulations (e.g., SEC proposal) and frameworks (e.g., ISSB, TCFD, etc.).

To effectively meet the rising bar for ESG data, companies will need to leverage existing data programs, utilize auditing and management systems, and, most importantly, put people at the center to help drive the execution of processes and solutions. Many companies will be able to use existing data for energy, waste, water, etc. to make a start. Almost every operational site is likely to have EHS functions as well as central corporate data collection systems. As such, companies should build on existing data, people, and processes like management systems, audits, and reporting that are already in place.

Successful implementation of the CSRD requires consultation across a broad range of internal stakeholder groups accompanied by robust and rigorous engagement processes. Those in charge of CSRD compliance will need to work across functions and boundaries, implementing ESG requirements by leveraging existing processes and putting people at the center of implementation to help drive alignment and maximize efficiencies. In the context of operations, some key questions that companies should be asking to enable a robust implementation are:

- Is our current data gathering system sufficient to cope with over 1,000 new CSRD data points?
- Do we have sufficient digital systems across the organization to process and analyze the CSRD data?
- Are our CSRD reporting data flows assurance ready?
- Where are the impact hot spots in my organization's value chain?
- At what cost can performance improvements be made?
- What capacity development and awareness readiness programs will my organization need to run to be ready?
- To whom in the organization should responsibilities should be allocated?
- How can we make sure that different internal functions can work together to ensure compliance?



4. Ensuring Impact: How Companies Can Leverage CSRD Compliance

The investment required to comply with the CSRD is likely to bring real value beyond detailed ESG disclosure. Creating a reporting system that offers visibility of all ESG impacts related to the company provides many potential benefits, ranging from access to a lower cost of capital and stronger reputation to assessing market- and cost-saving opportunities more effectively.

Alternatively, non-compliance will almost certainly generate many headaches, from possible administrative penalties (such as financial sanctions) and exclusion from investment portfolios to reputational damage and a weakened position when attracting talent. Even before considering all other benefits, the costs of aligning a company's reporting processes with the CSRD far outweigh the negative consequences of noncompliance.

Below we outline some of the benefits that CSRD compliance can bring to companies:[29]

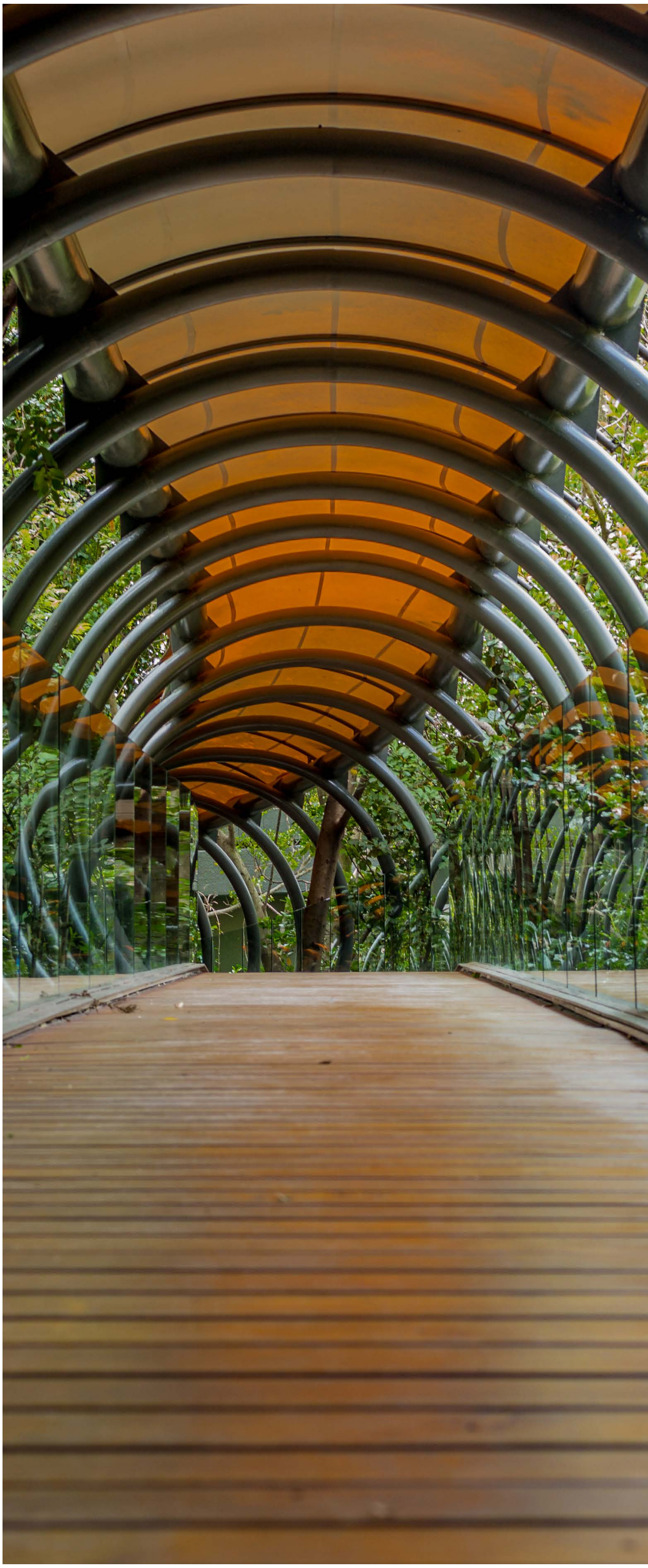
- **Performance assessment and benchmarking:** Companies can utilize the findings from data collection and disclosure activities to get a better picture of their ESG performance. This improved understanding can then be used to benchmark against peers or past performance to encourage new insights and ideas, strategic repositioning, and innovation.

- **Securing internal buy-in:** The evolution of ESG-related disclosure is a strong motivation for companies to move ESG from a "nice-to-have" or "check-the-box" activity towards a business imperative. By conducting a performance assessment and benchmark, disclosures can be used to embed ESG into a company's strategy and culture, encouraging action on ESG-related issues from the top down. This will help secure internal buy-in from leadership and further integrate ESG-related considerations into a company's operations.

- **Integrating ESG-related disclosures into business strategy and core operations:** CSRD facilitates integration of ESG-related disclosures into core business strategy by mandating integrated financial and non-financial reporting, double materiality assessment, risk management, performance metrics, and investor/stakeholder engagement.

- **Risk and opportunity identification:** Improved understanding of the risks, opportunities, and impacts that a CSRD-aligned materiality assessment requires means that companies will be better suited to anticipate and manage them in the future. Companies are likely to reduce financial losses by better preparing for risks and increasing commercial gains by capitalizing on identified opportunities.

- **Resource efficiencies:** The CSRD's standardization of sustainability reporting aligns with several voluntary reporting frameworks such as SASB, TCFD, GRI, etc. Alignment with these frameworks and the consolidation of data collection and disclosure activities will likely help companies implement process efficiencies. Ultimately, consolidation may end up helping companies save money.
- **Access to and cost of capital:** Particularly when considering the EU's SFDR requirements, CSRD compliance may make companies more attractive to investors. The CSRD's requirements not only help companies assess and address risks more effectively but also provide increased transparency into a company's operations and in turn may make companies a more attractive investment. Businesses leading the sustainability transition and those with ambitious transformation programs underpinned by investor-grade plans will further benefit from a more attractive cost of capital, whether that is through equity or debt.
- **Reputational benefits:** Society at large is demanding more sustainable and responsible activity from businesses. With CSRD's aim to reduce greenwashing and encourage more sustainable business activity, compliance may help companies gain a competitive advantage over those that do not make ESG a priority.
- **Improvement of company value:** CSRD data will be publicly accessible and gathered in a European Single Access Point Database (ESAP) with all other companies' data. This data will likely be used by ESG rating agencies, government authorities, private and institutional investors, activists, NGOs, and customers, among others. This will enable direct benchmarking and comparison. Due to these reasons, it is highly likely the ESG performance reported under the CSRD will have a direct impact on a company's business performance and valuation.



5. Conclusion: CSRD Foreshadows the Future of ESG Reporting

In the crowded field of ESG standards and regulations, the CSRD stands out. It pushes ESG disclosure requirements to new heights along three axes: its scope, level of detail, and emphasis on two-way impact. The directive will cover more than 50,000 companies, including 10,000 companies outside the EU. The CSRD's explicit focus on the supply chain and Scope 3 emissions is another impact that will be felt far beyond EU borders. And the introduction of double materiality mandates the reporting of companies' impact on the planet and society for the first time.

Companies should reflect on what the CSRD teaches the private sector about the direction of ESG regulation in the EU and globally. Since 2014 the ESG ecosystem in Europe has expanded in scope and ambition, with the CSRD as its latest, but certainly not final, step. The EU's philosophy underpinning this trend is increasingly in focus: the bloc strives for standardized and quantified ESG disclosures at par with financial reporting to scrutinize companies' ESG claims. This means that ESG reporting irregularities could (and probably will) trigger the same legal consequences as misleading financial reporting.

At a practical level, the best way for companies to start preparing is to apply the four-stage process described in this briefing: discover, design, implement, and report. CSRD's detailed requirements can seem overwhelming but going through these four steps will help simplify the process. Companies should also bear in mind that perfection is often the enemy of good enough. The complexity of the CSRD and its requirements mean that getting started is more important than trying to get it exactly right. Implementing CSRD will likely be a years-long learning process.

The ESRS framework is expected to be formally approved in 2023 and will be followed by the approval of sector-specific standards in 2024. Assurance requirements are likely to rise in intensity over time. However, companies should not use these open questions as an excuse to postpone preparations. In reality, preparing and complying will happen in a continuously changing environment. Not only are the CSRD and ESRS likely to change shape over time, but companies will also need to prepare for other ESG-related directives like the CSDDD.

Despite the significant effort compliance will take, the benefits of investing in CSRD implementation will outweigh the costs. First, the negative financial and reputational impacts of non-compliance will be far greater and second, the biggest value will most likely come from the new business insights a CSRD-compliant ESG infrastructure will provide. All companies need to do is take a deep breath and get to work.

Glossary of Terms and Acronyms

Terms

Double materiality: the union of impact and financial materiality.

Financial materiality: considers those risks and opportunities that may financially impact a company's operations.

Impact materiality: considers both positive and negative impacts that a company's business activities may have on the environment or society at large.

Limited assurance: a baseline level of assurance where a third party auditor obtains sufficient and appropriate evidence to indicate there is no material misstatement made by the information or data in question.

Management report: an annual company report produced in compliance with EU requirements including information such as developments of importance, likely future developments, R&D activities, equity information, etc. All information required by the CSRD is to be disclosed in a company's management report.

Materiality: a determination of which issues are most important to an organization and could influence the decision-making process of company stakeholders.

Micro-undertakings: Companies in the EU that do not exceed two of the following three limits: a balance sheet of €350,000, net turnover of €700,000, or 10 employees.

Reasonable assurance: a strong level of assurance where a third party confirms a high likelihood that material misstatements will not be detected.

Acronyms

CSRD: Corporate Sustainability Reporting Directive

EC: European Commission

EFRAG: European Financial Reporting Advisory Group

ESG: Environmental, Social, and Governance

ESRS: European Sustainability Reporting Standards

EU: European Union

GRI: Global Reporting Initiative

IFRS: International Financial Reporting Standards

ISSB: International Sustainability Standards Board

NFRD: Non-Financial Reporting Directive

SASB: Sustainability Accounting Standards Board

SEC: Securities and Exchange Commission (United States)

TCFD: Task Force on Climate-Related Financial Disclosures

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About The SustainAbility Institute by ERM

The SustainAbility Institute is ERM's primary platform for thought leadership on sustainability. The purpose of the Institute is to define, accelerate, and scale sustainability performance by developing actionable insight for business. We provide an independent and authoritative voice to decode complexities. The Institute identifies innovative solutions to global sustainability challenges built on ERM's experience, expertise, and commitment to transformational change.

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