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The European Union requires sustainability reporting from any company with more than 250 employees starting from the financial year 2023

REPORTING OBLIGATION OF CLIMATE-RELATED INFORMATION WILL BE SIGNIFICANTLY EXPANDED AND ENHANCED THROUGH NEW EU LEGISLATION COMING INTO EFFECT IN 2024

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The EU Taxonomy Regulation and the Corporate Sustainability Reporting Directive (CSRD) are new rules that EU institutions have developed to make more companies disclose their sustainability information in a more adequate manner.

Who will be affected by these new rules?

The Corporate Sustainability Reporting Directive CSRD establishes the reporting requirements to:

- All large companies, financial and non-financial, listed and non-listed. It is considered that a large company is one that meets two out of three of the following criteria:
  - €40 million in net turnover
  - €20 million on the balance sheet
  - 250 or more employees
- Small and medium-size listed enterprises. It is considered that a SME is one that meets two out of the three following criteria:
  - Between €8 million and €40 million net turnovers
  - Between €4 million and €20 million on the balance sheet
  - Between 50 and 250 employees

Note: SMEs will get an extra 3 years to comply.

In addition to the **CSRD**, the **EU Taxonomy** applies to **all financial market participants** that make available financial products in the EU, e.g. insurances, investment firms, pension funds, venture capital funds, or banks and credit institutions which provides portfolio management.

How will companies and financial market participants be affected? What will be required of them?

The EU taxonomy regulation could be considered as a classification system to determine whether an economic activity qualifies as environmentally sustainable or not.

The taxonomy establishes that an economic activity can only be considered environmentally sustainable if:

- It makes a substantive contribution to one of six environmental objectives
- It does no significant harm to the other five
- It meets minimum safeguards (e.g., UN Guiding Principles on Business and Human Rights, OECD Due Diligence Guidance for Responsible Business Conduct)

Taking into account these three bullet points, the taxonomy imposes new disclosure obligations for companies and financial market participants.

Companies subject to this regulation are required to include a description of how, and to what extent, their activities are associated with Taxonomy-aligned activities. The disclosure must include:

- The proportion of turnover aligned with the Taxonomy
- The Capital Expenditures and, if relevant, Operational Expenditures aligned with the Taxonomy

Note: The six environmental objectives are:

- *Climate change mitigation.*
- *Adaptation to climate change.*
- *Sustainable use and protection of water and marine resources.*
- *Transition to a circular economy.*
- *Pollution prevention and control.*
- *Protection and recovery of biodiversity and ecosystems.*

It is recommended that companies complete the Taxonomy calculation separately for each of the environmental objectives. This way it will be easier for the company to adapt to the established timing because companies have to provide information about their activities that substantially contribute to climate change mitigation and adaptation in 2022, and for all six environmental objectives in 2023.

Financial market participants will have to disclose to what extent the activities that their financial products fund meet the EU Taxonomy criteria. For each relevant product, it is required to state:

- How and to what extent they have used the Taxonomy in determining the sustainability of the underlying investments.
- To what environmental objective(s) do the investments contribute.
- The proportion of underlying investments that are Taxonomy-aligned, expressed as a percentage of the investment, fund, or portfolio.

The disclosures must be made as part of regular reporting requirements. Financial market participants will be required to complete their first set of disclosures covering activities that substantially contribute to climate change mitigation and/or adaptation, by the 31st of December, 2021.

The CSRD is still a proposal that updates the previous Non-Financial Reporting Directive (NFRD). The objective of the Directive is to guarantee that companies report how sustainability issues affect their businesses, and about how their own businesses affect people and the environment ("double materiality perspective").

Note: The European Commission proposes a "limited" assurance requirement to start, but it is expected that it will shift into a "reasonable" assurance in the medium term.

The proposal requires companies to:

- Report in accordance with the new **EU sustainability reporting standards** that will be adopted in 2022.
- Publish all the information as part of the **periodic management reports**, rather than in a separate report.
- Publish the information in **digital and machine reading format** (XHTML format). Thus, this information will be incorporated in the European Single Access Point.
- Compulsorily integrate third-party audits to verify the information. The information has to be subject to a **limited level of audit assurance.**
- Include in the report a **description of the business model and strategy** in relation to sustainability matters of the company that defines:
    - Company's resilience to **risks** related to sustainability issues.
    - **Opportunities** arising from sustainability issues.
    - Company's **plans** to ensure that its business model and strategy are compatible in an economic system that limits global warming to 1.5 ° C in line with the Paris Agreement.
    - **Objectives** and **progress** made related to sustainability.
    - Company **policies** regarding sustainability.
    - **Due diligence** process applied in relation to sustainability.
    - Main actual or potential **negative effects** related to the company's value chain, including operations, products, and services, commercial relationships, and supply chain.

It is expected that large companies will have to start complying with the new sustainability reporting standards in 2024, covering the business year 2023, while SMEs will have to comply in 2026. This allows time for companies to start adapting to the requirements established by the EU taxonomy that come into effect in 2022 and 2023.

How should companies and financial market participants prepare?

Companies and financial market participants should prepare on two levels to perform adequately:

- **On the one hand, they have to learn to comply with the new reporting rules.**
- **On the other hand, which is both more relevant and more challenging, they have to progressively improve the sustainability of their business models and business operations in order to be able to report progress towards the adaptation to a green economy.**

The **CSRD** refers to the new EU sustainability reporting standards that will be adopted in 2022. Nevertheless, the objective of CSRD is to reduce complexity and the potential for duplicative reporting requirements, therefore the new reporting standards will align with the other EU initiatives on sustainable finance like the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation. In this line, companies should:

- Update their guidelines based on frameworks that the European Commission developed such as the Guidelines on non-financial reporting of environmental and social information or the guidelines on reporting climate-related information that integrate the Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) and the EU taxonomy. These guidelines are especially useful to avoid stereotyped texts or simply filling in boxes.
- Get used to representing information with a combination of descriptive reporting, quantitative data, and visual presentations because the simple use of indexes and key performance indicators will not be enough for complying with the CSRD.
- Start incorporating the role of the auditor to verify sustainability information that the company discloses.

Resources:

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