Newsletter:

Sustainability reporting by companies

January 2023

Dear reader,

By introducing the Corporate Sustainability Reporting Directive ("CSRD"), the European Commission aims to expand its sustainability disclosure requirements, both in terms of scope, and content. The CSRD requires companies to publish this information in a standardised way and to have it independently audited.

We discuss the new obligations below and focus on what is relevant for HR professionals.

Enjoy the read!

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1 Introduction

The European Corporate Sustainability Reporting Directive ("CSRD") was published on 16 December 2022. The CSRD amends the reporting obligations of the Non-financial Reporting Directive ("NFRD"). The NFRD required larger companies, the so-called entities of public interest, to report annually on their environmental, social and human resources issues. In Belgium, these reports are part of the "non-financial statement", which is included in the annual report of the board of directors to the shareholders (Art. 3:6, §4 BCCA).

Reports of the European Commission showed that the information reported by various under the NFRD was inadequate. The term "non-financial reporting" was perceived as misleading because this information does have a financial impact. Therefore, the CSRD uses the term "sustainability information".

By introducing the CSRD, the European Commission aims to expand its sustainability disclosure requirements, both in terms of scope, and content. The CSRD requires companies to publish this information in a standardised way and to have it independently audited.

We discuss the new obligations below and focus on what is relevant for HR professionals.

2 Which companies?

Just like the NFRD, the CRSD applies to large entities of public interest, i.e., listed companies, banks and insurers with more than 500 employees.

The CSRD will broaden the scope of the previous directive by extending the reporting obligations to:

(1) large companies, even if they are not considered as public interest entities, and;
(2) listed small or medium-sized enterprises (but excluding micro-enterprises).

The definitions of micro, small, medium-sized and large enterprises refer to existing concepts in accounting law.

Sustainability reporting is in principle consolidated at the highest level within the European Union. Subsidiaries can then simply refer to the consolidated information of their parent company.

Companies based outside the EU which have activities within the EU and which meet the same criteria in terms of size are also targeted by the new requirements.

3 Which information?

The CSRD is characterised by a "double materiality perspective", which requires companies to report:

(1) from the perspective of the risk and the impact of ESG factors on the company, and

(2) from the perspective of the company's ESG impact.

Each of these two materiality perspectives should be considered in its own right, and information should be provided when it is essential from one or both perspectives.

The CSRD requires reporting on:

- the business model and sustainability strategy,
- the resilience of the group's business model and strategy in relation to risks related to sustainability matters,
- the opportunities for the group related to sustainability matters,
- the plans of the group, including implementing actions and related financial and investment plans,
- how the group's business model and strategy take account of the interests of the group's stakeholders and of the impacts of the group on sustainability matters,
- the role of the administrative, management and supervisory bodies with regard to sustainability matters,
- the existence of any incentive schemes linked to sustainability matters,
- the due diligence process implemented by the group with regard to sustainability matters,
- the actual or potential negative impacts of the business and how they are identified,
- any actions taken by the group to prevent, mitigate, remediate or bring to an end actual or potential adverse impacts, and the result of such actions,
- indicators relevant to the disclosures.

For SMEs, the required information is limited.

The foregoing information must be provided from the point of view of the enterprise itself. However, it should also gradually reflect its value chain, i.e., its products and services, its business relations and its supply chain. When companies do not yet have this information, they should explain how they will obtain it in the future.

Sustainability issues are defined as environmental, social and employee matters, respect for human rights, including the fight against anti-corruption and bribery matters and governance factors (i.e., the "ESG"). The CSRD goes one step further than the NFRD by explicitly targeting "governance factors".

Member States may allow companies to withhold the information when such disclosure could cause serious harm.

4 Standardisation

On 23 November 2022, the European Financial Reporting Advisory Group (EFRAG) published its first draft EU Sustainability Reporting Standards (see https://www.efrag.org/lab6). The European Commission will now consult EU bodies and Member States on the draft standards, before adopting the final standards as delegated acts in June 2023. It is noteworthy that these draft standards require reporting on "workers in the value chain", which encompasses employees and self-employed workers of the company and its upstream and downstream value chain (i.e., suppliers and customers impacted by the company). These sustainability reporting standards should avoid imposing a disproportionate administrative burden on undertakings, by providing an understandable, relevant, verifiable and comparable information. The Commission may determine which forward-looking and retrospective information should be provided. In addition to the foregoing, the Commission may decide which qualitative and quantitative information needs to be included.

To avoid unnecessary regulatory fragmentation that could have negative consequences for undertakings operating globally, the Commission will engage with global initiatives in this area by contributing to the process of convergence of sustainability reporting standards at the global level by supporting the work of the International Sustainability Standards Board. Information will eventually have to be delivered in a digital taxonomy so that it becomes available through ESAP, the European Single Access Point, for public company information.

5 External audit

Once the company has fulfilled its reporting obligations, the report itself should be audited by an independent and licensed auditor. The legislator created this external audit requirement to ensure that companies consistently comply with the reporting standards. The current "non-financial statement" under the NFRD was not subjected to any audit obligations.

The auditor would have to confirm whether the report was prepared in accordance with the requirements and standards. The audit process also implies that management will need to confirm in the management representation letter that the sustainability reports comply with the CSRD requirements.

Initially, the audit will be a limited assurance engagement, which is usually provided in a negative form. In time, this will become a "reasonable assurance" report, which is usually worded positively and thus would also require a heavier audit.

The audit can be carried out by a licensed sustainability assurance professional, who does not need to be an auditor. These service providers will be subjected to standards very similar to the existing standards for auditors, including training, accreditation, professional ethics and professional secrecy. Within existing audit firms, partners will have to specialise to act as "principal sustainability associate", whereby assurance standards and procedures will have to be developed.

6 Timeline

The CSRD is a directive that has to be transposed into national legislation. This legislation will come into force in four separate phases:

(1) Public-interest entities that were already governed by the NFRD should report on fiscal year 2024 by 2025;

(2) Larger companies that were not governed by the NFRD should report on fiscal year 2025 by 2026;

(3) Listed SMEs should start reporting on their fiscal year 2026 by 2027;

(4) Targeted non-EU companies should start reporting on their financial year 2028 in 2029.

7 Relevance from an HR director's point of view

In view of their position in the company, HR managers will be closely involved in the preparation of the annual sustainability reports, notably in the following areas:

7.1 The “S” in ESG

It is quite obvious that the HR manager will act as a guardian of the “social elements”. The exact details of the report have yet to be determined by the European Commission. However, it will have to include the following elements:

- equal treatment and opportunities for all, including gender equality and equal pay for work of equal value, training and skills development, the employment and inclusion of people with disabilities, measures against violence and harassment in the workplace, and diversity;
- working conditions, including secure employment, working time, adequate wages, social dialogue, freedom of association, existence of works councils, collective bargaining, including the proportion of workers covered by collective agreements, the information, consultation and participation rights of workers, work-life balance, and health and safety;
- respect for human rights, fundamental freedoms, democratic principles and standards established in applicable international conventions and EU standards;

The reporting obligation will go beyond the publication of quantitative information that needs to be published in the social balance sheet. As it implies an annual reporting obligation, thought should be given to systems that can measure, collect and audit the required qualitative data.

Given the double materiality perspective as discussed above, the analysis should take the following into account:

- **The outside-in perspective**; for example, how does poor diversity in management affect hiring, and how might it affect future business success?
- **The inside-out perspective**; for example, what is the effect of entrepreneurial activity on people and society?

The report will clearly go beyond the available HR data.

7.2 The “G” in ESG

Reporting on the “E”, the environmental factors will be taken care of by other parts of the organisation, but HR managers will be involved in the “G”, the governance factors. These include in particular:

- composition of and diversity within the board of directors and management;
- the remuneration policy, in particular the variable remuneration of directors and management, and the extent to which it is linked to sustainability objectives;
- business ethics and corporate culture, including anti-corruption and antibribery, the protection of whistleblowers (read more about this in our newsletter).

Just as for the paragraph above, the reporting standards are yet to be set out by the European Commission.

7.3 Employee consultation on sustainability reporting

The CSRD requires the management of the company to inform its employees and its representatives on how sustainability information is collected and how it gets verified. Social dialogue on sustainability issues can be considered as one of the objectives of the directive.

It can be expected that Belgium will implement the obligation by introducing a requirement to discuss sustainability reporting in the annual session with the works council on the financial statements .

A proper implementation of the CSRD will benefit the reputation of the company. Additionally, a transparent and positive reporting culture will potentially provide a competitive advantage in attracting and retaining talent.

8 Conclusion - what's next?

Many companies are already focused on ESG nowadays. The arrival of the CSRD is likely to result in a more efficient data management system around ESG topics and will result in a new ESG audit industry. HR managers will have an important role to play within companies. Furthermore, companies will not be allowed to limit their analysis, processes and tools to solely themselves; they will have to assess the social impact of their suppliers and the effects of their own activities on other stakeholders.

The European Commission wants to take this a step further, whereby it wants companies to focus on sustainability in their supply chain. In order to form a response to the growing concern around purchasing goods from suppliers that are less than compliant with ESG standards, a proposal for a directive is on the table that will require companies to start carrying out due diligence on their suppliers and monitor compliance with ESG standards in their supply chain. This proposal is now being discussed in the Council of Ministers and the European Parliament.

We will continue to monitor this and other ESG topics that are of interest to HR.

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