ESG REPORTING AND DISCLOSURES

Implications for boards and business leaders

Recently adopted legislation around mandatory EU sustainability/ESG (environmental, social, and governance) disclosures and forthcoming mandatory human rights, environmental and governance due diligence legislation will fundamentally impact business operations. Companies, especially those operating in the EU, will need to be aware of far reaching forthcoming regulatory and reporting requirements in order to align their internal operations in time.

Compared to the EU, the UK has not yet developed a comprehensive framework for ESG reporting or new regulations on ESG in supply chain management, instead preferring international standards. It will be important that companies are cognisant of the different regulatory and political approaches to ESG and sustainability disclosures in the EU and the UK to better navigate the aftermath of Brexit.

However, rather than viewing ESG regulatory requirements as burdens, business leaders would be better looking at them as opportunities to better embed ESG within corporate strategy, effectively enhancing risk management, gain competitive advantages, attract investment and funding as well as deliver value for their businesses and society at large. Businesses that have the foresight to prepare their internal processes and operations well in advance can gain competitive advantages.

Current & forthcoming ESG legislation and policy in the EU

Two EU legislative files are likely to have widespread implications for companies: recently implemented obligations for sustainability disclosures and a forthcoming mandatory human right, environmental and governance due diligence proposal. These proposals introduce new disclosure obligations as well as forthcoming substantive obligations to address ESG issues in companies' supply/value chains.

Under the Corporate Sustainability Reporting Directive (CSRD), all large, listed, and some non-EU companies will be required to report sustainability information against mandatory European sustainability reporting standards. This is a fundamental change to the current situation. The new requirements will have implications on how companies measure, account and disclose their sustainability risks, opportunities, and impacts.

Investors and other users of ESG data, who have been operating in a context scarcity, will have access to more consistent ESG information. This in turn will put pressure on companies, including those not falling within the scope of the proposals, to provide the market with more robust and detailed ESG data. Regulatory developments are therefore a driving force in this space.

Importantly, CSRD applies double materiality, so companies must disclose how sustainability issues can affect the company but also how the company itself impacts society and the environment. For companies that have in the past assessed only risks to their own business rather than their external impact, CSRD implies a fundamental shift in thinking and subsequent reporting.

New detailed sustainability reporting standards are also being developed by the European Financial Reporting Advisory Group (EFRAG) The standards will be tailored to EU policies, while building on and contributing to international standardisation initiatives. For companies that fall within the scope of CSRD, these standards will become mandatory.

Importantly, companies will need to report sustainability information in a dedicated section of the management report rather than in a 'standalone' sustainability report (which is usually the common practice). This means that financial and sustainability information will be published at the same time and that management will be accountable for this reporting.

Furthermore, the ESG report and the sustainability information provided by the company will become subject to either an audit by a statutory auditor or an assurance process by a recognised assurance provider. Again, this has important implications for businesses given that the status of the 'non-financial' information will now become more on par with the traditional financial information that a company provides. The EU has made clear that its final aim is to ensure that sustainability reporting should be as important as 'traditional' financial reporting, closely aligning the two together. CSRD will thus require boards to be a part of the company's due diligence process and to sign off on sustainability information within a company's management report.

The second important development is a proposal for a Corporate Sustainability Due Diligence Directive (CSDDD). This proposal explicitly establishes and adds a substantive corporate duty for companies to perform due diligence to identify, prevent, mitigate, and account for external harm resulting from adverse human rights and environmental impacts in the company's own operations, its subsidiaries and in the value chain. Companies will therefore need to ensure they have adequate governance, management systems and processes in place to comply with these forthcoming requirements.

The proposal will also introduce directors' duties for directors of EU companies (large EU companies or non-EU companies active in the EU[1]) to set up and oversee the implementation of the due diligence processes and to integrate due diligence into the corporate strategy. The directive will set obligations for companies to have in place a plan ensuring that the business model and strategy are compatible with the transition to a sustainable economy. The proposal also includes sanctions and a civil liability regime.

The proposed directive is currently going through the EU legislative process (it is currently being discussed in the European Parliament and the Council) and is scheduled for adoption in spring 2023. However, the European Parliament is likely to add to the criteria proposed by the Commission, while the Council, represented the member states, has already slightly softened some of the Commission's original provisions, for instance around directors' duties. It will thus likely be subject to intense negotiations between the co-legislators before an agreement will be reached.

However, even if the exact final shape and form of the directive is not yet fully known, the direction of travel is clear. Business leaders and boards should be prepared that mandatory due diligence obligations and extended directors' duties are likely to become EU law.

Interlinkages/complementary nature of the two directives

According to the Commission, the two directives are closely interrelated and will lead to synergies. For example, under the CSRD, the information collection a company must do to report properly will requires setting up robust internal and external processes to identify adverse impacts (internally and externally). This mirrors the due diligence requirements under CSDDD, with CSRD covering the last step of the due diligence duty, namely the reporting stage.

It is also worth mentioning that the CSRD aims to be closely linked with the EU Taxonomy, a green classification system that translates the EU's climate and environmental objectives into criteria for specific economic activities for investment purposes. However, in practice, there are several overlapping ESG/sustainability reporting requirements, especially for financial services companies, most notably the Sustainable Finance Disclosure Regulation (SFDR), which require financial market participants to publish a statement on their due diligence policies with respect to principal adverse impacts of their investment decisions on sustainability factors.

In theory, the various EU directives and regulations should complement each other. However, this is not always the case.

ESG divergence between the EU and the UK

In contrast to the EU, there is no overarching sustainability reporting or ESG legislative framework in the UK. Instead, there are various pieces of legislation and/or guidance for companies on ESG aspects, primarily derived from the UK Corporate Governance Code, the Companies Act and the Disclosure Guidance and Transparency rules. However, these are mostly principle-based (rather than rules-based) disclosures and not (as is increasingly the case in the EU) mandatory.

[1] The Directive will apply to EU companies with 500+ employees generating a €150M turnover, or with 250+ employees and a €40 million turnover operating in the agriculture, mineral and textile sectors. Non-EU companies generating a €150M turnover or a €40 million turnover in the aforementioned sectors are also in scope.

In fact, mandatory reporting in the UK only applies for mainly large, listed companies on some very specific issues; around greenhouse gas reporting[2], energy use[3], gender pay gap and preventing modern slavery.

In the financial reporting area, the UK has implemented some corporate disclosures stemming from the Task Force on Climate Related Financial Disclosures (TCFD) but the detail of the wider regulation is still under development. Companies will be required to disclose climate-related financial information, ensuring they consider the risks and opportunities they face as a result of climate change. The UK has announced its intention to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements already due to be in place by 2023.

This has led to concern about the alignment of the EU/UK regimes. It is likely that the EU and the UK will develop different frameworks. Businesses therefore need to understand and adapt to these changes.

Strategic implications for boards and business leaders

ESG issues are becoming increasingly relevant to businesses and forthcoming regulatory developments at EU-level will have significant implications for EU and non-EU companies alike, putting ESG front and centre for boards.

The EU proposal for a CSDDD explicitly establishes a "duty to act" on sustainability, climate, and human rights impacts of the company. Both the EU's CSRD and the forthcoming CSDDD set out ambitious new guidance on the personal duties of directors. Given the explicit link between these proposals and corporate strategy, business leaders need to be strategically involved on these issues. The introduction of financial liabilities in addition to the board members' fiduciary duties further support this.

Board engagement on ESG issues is also valuable in creating a better understanding between boards and management. Senior executive training for board members – such as the Competent Boards™ Programme from Ibec Academy Global - can help bring the board members up to date and train them how to deal with ESG issues in an increasingly complex landscape.

Corporate leadership also need to be aware of the different regulatory and political approaches to ESG and sustainability disclosures in the EU and the UK in order to navigate the aftermath of Brexit better. But although the UK ESG framework looks less stringent and cumbersome for businesses compared to the EU one, investors will likely start to expect companies to provide them with more robust ESG data to better understand how boards manage ESG risks and if and how they are capitalising on relevant ESG opportunities.

Rather than looking at ESG regulatory requirements as burdens, business leaders and boards would be better viewing them as opportunities. The research on the return on sustainability investment, as recently reported in Harvard Business Review[4], has demonstrated that embedding sustainability into business strategy can create competitive advantage for business leaders by driving operational efficiency, innovation, employee engagement, supply-chain resilience, risk mitigation, sales, among other strategic business benefits. The regulatory drivers for change as outlined should thus be seen as an impetus for boards to fully embed ESG within their corporate strategy.

[2] Mandatory for quoted companies since 2013 under the Companies Act 2006
[3] Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018
[4] ESG Reports Aren't a Replacement for Real Sustainability (hbr.org)