SUSTAINABILITY REPORTING

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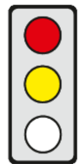
KEY ISSUES

Context: Since 2018, the Non-Financial Reporting Directive requires certain companies to publish sustainability information. The Commission takes the view that the existing scope of reporting fails to meet the needs particularly of investors and non-governmental organisations.

Objective of the Directive: Many more companies than before will be obliged to carry out significantly more comprehensive sustainability reporting.

Affected parties: Large companies, listed small and medium-sized companies (SMEs), banks, insurance companies, investors, non-governmental organisations.



Pro: The external auditing of sustainability reporting may increase the reliability of reporting and prevent greenwashing.

Contra: (1) In principle, an obligation to carry out sustainability reporting should be rejected. However, disclosure rules for financial market participants, that have already been introduced, make reporting obligations unavoidable.

(2) The obligation to carry out sustainability reporting should not be based on the size or capital-market orientation of the company.

(3) Setting mandatory EU reporting standards will undermine international efforts to consolidate reporting obligations and make uniform reporting impossible for globally operating companies.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2021) 189 of 21 April 2021 for a **Directive** amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, **as regards corporate sustainability reporting**

Brief Summary

Unless otherwise indicated, article numbers refer to the Accounting Directive 2013/34/EU.

► **Context and objectives**
- Since 2018, under the Non-Financial Reporting Directive [2014/95/EU, see cep**PolicyBrief**], which amended the Accounting Directive [2013/34/EU], certain companies have to publish information relating to environmental, social and employment matters, respect for human rights and efforts to combat bribery and corruption [p. 1].
- The primary users of this information are investors as well as non-governmental organisations (NGOs), social partners and other stakeholders [p. 2].
- According to the Commission, sustainability information often fails to meet the needs of users. This is because [p. 2]
  - some companies do not report such information, or do not report it fully, because e.g. they are not obliged to do so,
  - the information is often difficult to find, not reliable or comparable and rarely available in a machine-readable digital format.
- The Commission therefore wants to [p. 4]
  - oblige more companies – approx. 49,000 in total – to carry out sustainability reporting (“Who”),
  - clarify what information must be provided by companies (“What”),
  - specify the form in which companies must provide the information (“How”),
  - prescribe stricter auditing of sustainability reporting, and
  - determine when the new sustainability reporting obligations will apply (“When”).

► **Who must report?**
- The obligation to carry out sustainability reporting applies to companies that [amended Art. 1 (1), new Art. 1 (3), amended Art. 19a (1)]
  - as large undertakings, fulfil at least two of the following three criteria:
    - more than 250 employees,
    - balance sheet total of more than € 20 million,
    - annual turnover of more than € 40 million;

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  - as small and medium-sized undertakings (SMEs), are listed on an EU regulated markets and meet at least two of the following three criteria:
    - 50 to 250 employees,
    - balance sheet total of between € 4 and € 20 million,
    - annual turnover of between € 8 and € 40 million
- The obligation also applies to parent companies of large groups, i.e. groups which, at group level, meet the criteria for large undertakings [Art. 29a (1)].
- The obligation also applies to
  - non-EU companies listed on EU regulated markets [amended Art. 4 Transparency Directive],
  - large banks and insurance companies irrespective of their legal form, including cooperatives and mutual undertakings [new Art. 1 (3), amended Art. 19a (1)].

► **What must be reported?**

- Reporting must cover the following "sustainability matters" [new Art. 2 No. 17, amended Art. 19a (1)]:
  - environmental, social and employee issues,
  - respect for human rights,
  - combating bribery and corruption and
  - "governance factors".
- When reporting, companies must take account of the principle of "double materiality". They must report on [Recital 25, amended Art. 19a (1), amended Art. 29a (2)]
  - the impact of their activities on sustainability matters ("inside-out" perspective) and
  - the influence of sustainability matters on their business development, performance and position ("outside-in" perspective).

  Companies must disclose information that is "material" from both perspectives as well as information that is "material" from only one perspective [Recital 25].
- Reporting must cover, in particular [amended Art. 19a (2), amended Art. 29a (2)]:
  - the company's business model and strategy, particularly whether these are in line with the aim of the Paris Agreement of limiting global warming to 1.5 °C;
  - the company's targets on sustainability matters and its progress towards achieving them;
  - the role of the administrative, management and supervisory bodies regarding sustainability matters;
  - the due diligence processes implemented regarding sustainability matters;
  - the "principal" adverse impacts of sustainability matters on the company's entire value chain;
  - the "principal" risks to the company related to sustainability matters and their management; and
  - indicators relevant to all the said areas.
- Reporting must [amended Art. 19a (2) and (3), amended Art. 29a (2) and (3)]
  - contain forward-looking and retrospective information,
  - contain qualitative and quantitative information,
  - where appropriate, take account of short, medium and long-term horizons,
  - include intangibles, e.g. human capital and intellectual property, and
  - describe the process used to identify the information reported.

► **How is reporting to be carried out?**

- The companies that are obliged to report must include the sustainability information in their respective management reports [amended Art. 19a (1), amended Art. 29a (1)].
- The Commission will adopt delegated acts to establish sustainability reporting standards [amended Art. 19a (4), new Art. 19b, amended Art. 29a (4)]
  - by the end of October 2022, for the initial information to be reported; this must cover, in particular, the information that financial market participants need in order to comply with their sustainability-related disclosure obligations under the Disclosure Regulation [(EU) 2019/2088; see cep**Adhoc**], and
  - by the end of October 2023, for other, particularly sector-specific, information.

  The Commission will review the delegated acts every three years and will adjust them where necessary.
- By the end of October 2023, the Commission will also adopt specific delegated acts on standards for SMEs, for both SMEs listed on EU regulated markets and all other SMEs [amended Art. 19a (5), Art. 29a (5), new Art. 19c]. The latter are not obliged to apply the standards [Recital 18].
- When preparing the delegated acts, the Commission must take account of [new Art. 19b (3)]:
  - the work of global standard-setting initiatives, e.g. the Global Reporting Initiative (GRI), and
  - the information that financial market participants need to comply with their disclosure obligations under the Disclosure Regulation [(EU) 2019/2088].
- The European Financial Reporting Advisory Group (EFRAG) will support the Commission in the adoption of the delegated acts, by way of "technical advice". This must be subject, in particular, to public oversight and transparency. [new Art.19b (1), amended Art. 49]
- Companies must prepare their management reports in a single electronic reporting format which allows for the sustainability information to be tagged [new Art. 19d].

- **Auditing of sustainability reporting**
  - Statutory auditors or auditing firms must verify whether sustainability reports comply with the requirements of the Accounting Directive [amended Art. 34 (1)].
  - Member States can also allow an "independent assurance services provider" to audit the sustainability reports. The latter must observe the requirements for auditing sustainability reports under the Auditors Directive. [amended Art. 34 (3)]
  - The Commission will establish, in delegated acts, standards for a "reasonable assurance" which will provide a basis for the audits [new Art. 26a Auditors Directive]. Until the standards exist, the audit must take place on the basis of "limited assurance" [amended Art. 34 (1)].
- **When is reporting to be carried out?**
  - The new reporting obligations apply [amended Art. 19a (1); Art. 5 of the Amending Directive]
    - to large undertakings, banks and insurance companies for financial years starting in 2023,
    - to SMEs listed on EU regulated markets for financial years starting in 2026.

Main Changes to the Status Quo

- Until now, the obligation to carry out sustainability reporting only applied to companies of public interest, i.e. listed companies, banks and insurance companies with over 500 employees (approx. 11,700 companies).
- The obligation to take account of the concept of double materiality has been clarified. The content of sustainability reports has been made more comprehensive and subject to additional requirements.
- The option to include sustainability information in a separate report no longer applies.
- In future, uniform EU standards will apply to reporting.
- The obligation to submit reports in electronic format has been introduced.
- Until now, under EU law, the audit report only had to indicate that sustainability reports had been submitted. In future, the content will also have to be audited.

Statement on Subsidiarity by the Commission

Different requirements on sustainability reporting and its assurance increase costs and complexity for companies operating across borders. This is detrimental to the single market.

Policy Context

The Amending Directive is part of the Commission's Sustainable Finance Action Plan [see cep**PolicyBrief**]. With the Disclosure Regulation [(EU) 2019/2088, see cep**Adhoc**], the EU has already created a set of rules for the disclosure of sustainability information by financial market participants vis à vis end investors. Under the Taxonomy Regulation [(EU) 2020/852, see cep**Adhoc**], all companies falling within the scope of this Directive on sustainability reporting, must disclose the proportion of their turnover and that of their capital and operating expenditure which is attributed to ecologically sustainable activities [see delegated act].

Legislative Procedure

21 April 2021	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Financial Stability, Financial Services and Capital Markets Union
Committees of the European Parliament:	Legal Affairs (leading), Rapporteur: Pascal Durand (Renew Group, FR)
Federal Ministry:	Justice
Committees of the German Bundestag:	Legal Affairs and Consumer Protection (leading)
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Legislative competence:	Art. 50 TFEU (Freedom of Establishment) and Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

The Commission sees an increased demand for sustainability information, particularly from investors and non-governmental organisations (NGOs), that is not being adequately met by companies. It considers this to be a failure of the market. This is not the case. If investors expect sustainability information, companies have a vested interest in publishing this information in order, for example, to obtain capital more easily. Failure to disclose thus indicates that the costs of reporting exceed the benefit. If, on the other hand, investors are not interested in sustainability information, the reporting obligation simply gives rise to higher costs for no appreciable gain. NGOs often have an interest in sustainability information. However, it is not the legislator's task to enable NGOs to exercise politically desirable pressure on companies by imposing reporting obligations. **In principle, therefore,** from an ordoliberal perspective, **an obligation to carry out sustainability reporting should be rejected.**

However, new **disclosure obligations for financial market participants, that have already been introduced** [(EU) 2019/2088, see cep**Adhoc**]**, make reporting obligations unavoidable**: Financial market participants must disclose the extent to which they take account of sustainability matters when making investment decisions. For this they rely on sustainability information from the companies in which they invest. Due to the aforementioned concerns, however, the extent of the reporting obligation should be kept to an absolute minimum.

The obligation to carry out sustainability reporting should not be based on the size or capital-market orientation of the company. Instead, it should apply generally and at the same time be designed to be proportionate. Firstly, it is not apparent that larger and listed companies automatically exert a more substantial impact on sustainability matters or are more affected by them. Secondly, unequal treatment in relation to the reporting obligations causes distortions of competition. Companies subject to the reporting obligation have to bear costs which do not apply to companies that are not required to report. Thirdly, the distinction gives rise to false incentives. Thus, for example, SMEs might refrain from financing via the capital markets if the reporting obligation applied to listed SMEs but not to non-listed SMEs.

There are currently numerous global and national standardisation initiatives on sustainability reporting with varying emphases. This variation means that reported information is often not comparable. The desire of many market players for global convergence, which also promotes capital market efficiency, is therefore understandable. **Setting mandatory EU reporting standards** is however inappropriate. The Commission **will undermine international efforts for a** gradual **consolidation of reporting obligations and make uniform reporting impossible for globally operating companies.** If the EU does introduce its own reporting standards, their application should be voluntary rather than obligatory.

The external auditing of sustainability reporting – initially with limited and later reasonable assurance **– may**, in principle, **increase the reliability of reporting and prevent greenwashing.** Making it mandatory is therefore appropriate. However, the Regulation fails to create adequate planning and legal certainty for the companies that are subject to reporting. There should be a clearer indication of when a change to the "reasonable" level of assurance is likely to take place and what form the assurance standards will take. The scope available to the Commission here is disproportionately large.

Currently, the obligation to carry out sustainability reporting applies to approx. 12,000 companies, in future it will be 49,000. Many of these newly included companies have had little previous experience with the disclosure of sustainability information. At the same time, large companies are already supposed to apply the new EU reporting standards as of 2023 even though these will not be established until October 2022. They will thus have only two months for adequate implementation. This time limit must be extended.

Legal Assessment

Legislative Competency

The Directive is correctly based on Art. 114 TFEU and Art. 50 TFEU.

Subsidiarity

Unproblematic.

Proportionality with Respect to Member States

Unproblematic.

Conclusion

In principle, an obligation to carry out sustainability reporting should be rejected. However, disclosure rules for financial market participants, that have already been introduced, make reporting obligations unavoidable. The obligation to carry out sustainability reporting should not be based on the size or capital-market orientation of the company. Setting mandatory EU reporting standards will undermine international efforts to consolidate reporting obligations and make uniform reporting impossible for globally operating companies. The external auditing of sustainability reporting may increase the reliability of reporting and prevent greenwashing.

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