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Preparing for upcoming climate and sustainability-related regulation and directives

The global landscape of climate and sustainability reporting and disclosure requirements is becoming increasingly complex, with more pressures on corporates to collect, validate, and disclose sustainability-related information and data.

Our high-level overview sets out the key takeaways of some of the main ESG-related directives that are in the pipeline, and what it means for UK business.

The UK's ESG regime consists of both domestic and EU-derived regulation, many of which are not specifically ESG-focused. The main sources for UK business consist of well-established regulations and laws such as the UK Corporate Governance Code 2018, the Companies Act 2006, the UK Stewardship Code 2020, the Climate Change Act 2008, the Bribery Act 2010, the Modern Slavery Act 2015 and more.

In addition, in April 2022, two new laws came into effect in the UK that together cover all UK registered companies and Limited Liability Partnerships (LLPs) with over 500 employees and with annual revenues of over £500 million – the "Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022" and the "Limited Liability Partnerships (Climate-related Financial Disclosure) Regulations 2022". These primarily focus on the requirement to, as part of strategic reporting, provide information in accordance with the Task Force on Climate-Related Financial Disclosures (TCFD). We are likely to see more legislation like this in the coming months and years as the ESG agenda continues to intensify.

This document will focus on some of the key ESG-focused regulation and non-mandatory reporting guidelines and frameworks currently facing businesses, and our understanding of current status and what to expect:

- IFRS Sustainability Disclosure Standards launched by the ISSB (International Sustainability Standards Board)
- CSRD (the Corporate Sustainability Reporting Directive)
- ESRS (EU Sustainability Reporting Standards)
- The EU Taxonomy
- TNFD (Taskforce on Nature-related Financial Disclosures)
- EUDR (EU Deforestation Regulation)

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IFRS Sustainability Disclosure Standards

In November 2021, at COP 26, the IFRS (International Financial Reporting Standards) Foundation Trustees announced the creation of a new standard-setting board – ISSB (the International Sustainable Standards Board) – with the intention of delivering a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions. Following extensive consultation during 2022, it is now understood that the ISSB will launch the IFRS Sustainability Disclosure Standards at the end of Q2 2023.

What can companies expect?

- The initial IFRS Sustainability Disclosure Standards, S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and S2 (Climate-related Disclosures), will become effective starting January 2024, for use in annual reports for the financial year 2024 and beyond.
- Both are expected to be applied together and propose reporting across four content areas: governance, strategy, risk management and metrics and targets – consistent with the TCFD Recommendations.
- The ISSB will embed the industry-based approach used by the Sustainability Accounting Standards Board (SASB) into the standard-setting process and will recommend its use for identifying the material sustainability issues to report on.
- The ISSB is expected to propose that sustainability reporting should be done at the same time as financial reporting for the same reporting periods, though this has been met with some resistance during the consultation process, so remains to be confirmed. This means reporting would need to be connected to financial statements to demonstrate a linkage between different 'significant' sustainability-related risks and opportunities.
- The ISSB is expected to direct focus to material impacts relevant for investors and creditors, applying the definition of materiality consistent with IFRS Accounting Standards: "*Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general-purpose financial statements make on the basis of those financial statements which provide financial information about a specific reporting entity*".
- The standards are positioned for global implementation, meaning they will be relevant across all markets, with further guidance and training material being developed to support corporate adoption of the standards.
- In the absence of directly applicable IFRS standards, the European Sustainability Reporting Standards (ESRS) may be positioned as a useful source of disclosures for S1. Equally, there is ongoing work to consider the application of GRI (Global Reporting Initiative) and how it relates to the standards.

It is expected that companies will need to implement the standards at pace, and so there is a need for business to quickly understand and adopt the new measures and apply them to their own contexts through identifying the issues most material to them. Organisations will be challenged to describe the resilience of their strategy, taking into consideration different climate-related scenarios, leveraging their existing materiality and TCFD processes.

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The Corporate Sustainability Reporting Directive (CSRD)

In April 2021, the EU Commission announced the adoption of the Corporate Sustainability Reporting Directive (CSRD). It received final approved by the EU Council in November 2022, taking effect on 5 January 2023. It amends the scope of the existing Non-Financial Reporting Directive (NFRD), expands the sustainability information required, and dramatically increases the number of companies subject to reporting requirements from approx. 11,700 under NFRD to over 49,000 under CSRD, covering almost 75% of total EU company turnover.

What can companies expect?

- CSRD will apply for eligible entities between 2024 and 2028, with EU Member States having until 16 June 2024 to transpose CSRD into national law. In principle, compliance will apply as follows:
    - Large, public-interest companies, with over 500 employees, already subject to NFRD will have to publish reports for financial years starting on or after 1 January 2024.
    - Large companies that are not currently subject to the NFRD (with more than 250 employees and/or €40m in net turnover and/or €20m in total assets), will be expected to publish reports for financial years starting on or after 1 January 2025.
    - SMEs will be expected to publish reports for financial years starting on or after 1 January 2026, but they can opt out for a two-year transitional period (financial years starting before 1 January 2028).
- Though it is an EU directive, the CSRD also applies to companies based abroad that have a presence in the EU, assuming over €150 million in EU annual turnover for the trailing two financial years, and at least one subsidiary with a large undertaking or EU branch that generated net turnover of more than €40m in the prior financial year. Assuming these requirements are met, sustainability information related to the non-EU undertaking will be required for financial years starting on or after 1 January 2028.
- CSRD will require companies to closely follow the EU's new sustainability reporting standards (ESRS) to disclose information about environmental and social risks and impacts, as well as the governance structures they have in place to manage risks and impacts. Sustainability reporting will likely need to be published at the same time as financial information.
- 'Double materiality' is a key element of the CSRD and requires the identification of both impact and financial materiality, i.e., how a company both impacts and is impacted by climate change.
- Value chain sustainability factors will also be required, specifically through reporting on Scope 3 emissions.
- CSRD also requires companies to set out clear ESG targets and provide disclosure and updates on progress and incentive schemes annually.
- CSRD will require mandatory 'limited level of assurance' from 2026 (by qualified third parties) with scope to also include EU taxonomy information. This may expand to more extensive assessment (reasonable assurance) in 2028.

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EU Sustainability Reporting Standards (ESRS)

In November 2022, the European Financial Reporting Advisory Group (EFRAG) submitted the first draft EU Sustainability Reporting Standards (ESRS) to the European Commission. The Commission is currently consulting on the standards among EU agencies and member states before adopting the final ESRS as “delegated acts” in June 2023, after which it will be put to the European Parliament and Council for scrutiny.

While the CSRD determines which companies must report, on what topics, where and when, the ESRS will clarify the information to be disclosed for each sustainability issue and how this should be reported. ESRS will be mandatory for companies under the CSRD and is designed with the aim of making ESG and sustainability reporting within the EU more accurate, consistent, and standardised, consolidating existing frameworks into one ESG standard which meets requirements of regulators, investors, and other stakeholders.

What can companies expect?

- Companies will be required to comply with the reporting requirements in phases, starting from financial years starting on or after 1 January 2024. SMEs will be obliged to report in line with the ESRS from 2026 but will have scope to opt-out until 2028.
- The ESRS aims to be aligned with already existing European policies and international standards, such as SFDR, TCFD, GRI etc, as well as the impending ISSB. Feedback to the ESRS has called for improvements to the structure for it to closely correspond with other frameworks, in particular TCFD and ISSB and reduce reporting burden / preparation costs for users.
- The twelve draft ESRS are categorised in 4 areas: *(Note: click link for more detail on each standard)*
    - Crosscutting**:** ESRS 1: General requirements; ESRS 2: General disclosures
    - Environment: Climate Change (ESRS E1), Pollution (ESRS E2), Water & marine resource (ESRS E3), Biodiversity & ecosystems (ESRS E4), Resource use & circular economy (ESRS E5)
    - Social: Own workforce (ESRS S1), Workers in the value chain (ESRS S2), Affected communities (ESRS S3), Consumers and end users (ESRS S4)
    - Governance: Business conduct (ESRS G1)
- The detailed qualitative and quantitative sustainability disclosures will be expected to be both forward-looking and retrospective, and capture short-, medium- and long-term time horizons.
- It will include requirements for double materiality to be considered, and consideration of a company’s entire value chains (predominately through Scope 3 emissions). EFRAG expands the notion of financial materiality in the context of sustainability reporting to include potential financial effects of the risks and opportunities likely to influence the company in the short, medium, or long term.
- In its current form, the standards are considered “sector agnostic”. EFRAG is working on a second draft ESRS to include a range of sector-specific standards across atleast five industries (agriculture, coal mining, mining and oil and gas), as well as five high-impact sectors (energy production, road transport, motor vehicle production, textiles and food and beverage), and additional guidance for SMEs. It is expected by June 2024.

The EU Taxonomy

The EU Taxonomy has been created to support the EU's climate and energy targets for 2030 and the objectives of the EU Green Deal, which offers a roadmap to climate neutrality by 2050. It is intended to boost sustainable investments, to improve resilience to climate change and navigate the transition to a low-carbon economy. It entered into force on 12 July 2020 and continues to evolve.

The EU Taxonomy is aimed at helping investors to understand whether an economic activity is environmentally sustainable and meets robust environmental standards. While the Taxonomy primarily acts as a science-based classification tool for investors, and a frame of reference for companies, it also has reporting implications requiring mandatory disclosure of Taxonomy-aligned activities for large companies within the scope of the NFRD/CSRD, starting from 1 January 2023.

What can companies expect?

- The Taxonomy enables market participants to identify and invest in sustainable assets and projects, through specific definitions and rules. At its core is the definition of a sustainable economic activity which is based on two criteria: that it contributes to at least one of six environmental objectives; and "does no significant harm" to any of the other objectives, while respecting basic human rights and labour standards.
- The six Taxonomy objectives are: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control and protection and restoration of biodiversity and ecosystems.
- Secondary legislation sets out the Technical Screening Criteria (TSC) including requirements and thresholds for how an activity is considered as contributing to these objectives or complying with the premise of "do no significant harm".
- Large, listed companies with over 500 employees will be required to disclose eligibility and alignment reports from January 2023, with the expectation that all listed companies, to include SMEs, will report on the simplified CSRD standard and the Taxonomy by 2027.
- Disclosures will include environmental performance information and detail on Taxonomy-aligned economic activities including taxonomy-compliant share of turnover, capital expenditure and operating expenses linked to atleast one of the six objectives (by referring to the appropriate TSC), how they 'do no significant harm' to the remaining criteria, and how they meet minimum social and governance safeguards.
- Non-EU companies will also be impacted as it applies to products and services that are manufactured and distributed in the EU. Equally, a non-EU company with EU-based investors may be expected to provide information aligning with the Taxonomy.
- Companies that do not fall within scope for mandatory disclosure can voluntarily use the Taxonomy for environmental sustainability strategies and communications.
- The UK, which has previously indicated it would base the UK taxonomy on its EU counterpart with legislation by the end of 2022, has recently 'paused' its taxonomy development with an update expected in early 2023.

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The Taskforce on Nature-related Financial Disclosures (TNFD)

A report from the World Economic Forum, *Nature Risk Rising*, estimates that $44 trillion of economic value generation is moderately or highly dependent on nature. In recognition of the huge importance of nature as it relates to our economies and systems, the TNFD was established in 2021, as a global, market-led risk management and disclosure framework for organisations to report and act on evolving nature-related risks. The aim of the TNFD is to support a shift in global financial flows away from nature-negative and towards nature-positive outcomes and increase the considerations of nature in financial and business decisions.

What can companies expect?

- The TNFD released the third beta version of its prototype risk management and opportunity disclosure framework (v0.3) in November 2022 for market consultation. The next update to the TNFD draft framework is due in March 2023 with final recommendations to be published in September 2023. It will start as a voluntary framework.
- The aim has been to develop a framework which can be applicable to, and used by, business and financial institutions irrespective of size, sector, jurisdiction, and approach to materiality. As such, the Taskforce is exploring an adaptable approach which provides a "core" set of disclosure requirements to set a baseline of adoption, alongside additional disclosure recommendations that would represent "enhanced" disclosure.
- It is expected to align with the IFRS Sustainability Disclosure Standards being developed by the ISSB.
- Aligning with the TCFD framework, TNFD is expected to address nature-loss and climate-change in an integrated way and will follow the four pillars of disclosure: governance, strategy, risk management, and metrics and targets (which are likely to be encouraged to be science-based). It will encourage reporting on nature-related impacts, risks, and opportunities, and importantly, add the dynamic of "dependencies". More resources are expected to be published to clarify the link between the two.
- TNFD is expected to focus on five drivers of nature change and positive/ negative impacts on nature: land/ocean/freshwater use change; climate change; resource use / replenishment; pollution / pollution removal; invasive alien species introduction / removal; and the four realms (ocean, freshwater, land and atmosphere).
- Identifying nature-related risk and opportunities should be approached using "LEAP", considering four stages of analytic activity: Locate interface with nature; Evaluate dependencies and impacts; Assess risks and opportunities and Prepare to respond and report to investors.

While further clarification on the final framework and guidelines is under development, companies can continue to apply and build on their TCFD frameworks and disclosures.

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EU Deforestation Regulation (EUDR)

The EU Deforestation-free Regulation (EUDR) is a new EU initiative to limit deforestation caused by forestry and agricultural activities all over the world. It expands, and will eventually replace, the existing EU Timber Regulation (EUTR). EUDR is expected to set out mandatory due diligence requirements for EU business and is being managed by the European Parliament and Council. It is not yet clear the date it will come into effect, but it is not expected before June 2024, with a consequent 18-month window to implement new rules.

What can companies expect?

- It will require companies to issue due diligence statements regarding goods placed on, or exported from, the EU market. Operators and Traders as defined under the EUDR will be required to implement due diligence on supply chains to ensure they are deforestation and forest-degradation-free, while traders will be responsible for storing and sharing information on their supply chain to operators.
- The regulation targets commodities and products derived from them with greatest impact on deforestation including coffee, cocoa, soy, palm oil, cattle (beef, leather), timber & timber products. It has also been expanded to include natural rubber.
- In order to prove products are “deforestation-free”, corporates will be required to prove that products were produced on land which was not subject to deforestation after 31 December 2020.
- It also includes considerations of human rights, and the rights of indigenous people.
- It is expected that businesses in scope will be “large” companies as determined through turnover as defined in the Companies Act.
- The extent and content of reporting is likely to include supply chain maps, environmental impacts and due diligence strategy, although the precise content is yet to be solidified.
- No specific country or commodity will be banned, but products will not be allowed to be sold in the EU with this proof of due diligence.
- Penalties for non-compliance with the regulation is expected to be set at the maximum of 4% of the total annual turnover in the EU of the infringing operator or trader.

The UK is taking a similar approach, with the Department for Environment, Food and Rural Affairs (Defra) recently consulting on the implementation of due diligence on forest risk commodities, amending the existing Environment Act 2021. The consultation closed in March 2022 with the government currently considering the development of secondary legislation. The due diligence provisions will make it illegal for larger businesses operating in the UK to use key forest risk commodities produced on land illegally occupied or used. Businesses in scope will also be required to undertake a due diligence exercise on their supply chains and to report on this exercise annually. Regulations are expected to be passed in 2023, with businesses to be given at least 6 months to prepare for regulation.

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What does this mean for business?

As the regulatory outlook continues to evolve, and companies are subjected to increasing requirements on their resources to meet legislation and wider stakeholder demands, it will be important for companies to continue to develop their ESG strategies and internal processes to support competitiveness, best practice, and compliance.

Our recommendation is for companies to work to understand and focus on the issues which are material to their specific business and industry, and ensure they are able to communicate this externally. We expect to see this focus on materiality emphasised in upcoming legislation, with the UK regulator, the Financial Reporting Council (FRC) hoping to encourage companies to focus on the important issues, and not get lost in trying to keep all stakeholders happy. Mark Babington, Executive Director of Regulatory Standards, Financial Reporting Council speaking at the ESG Integration Forum Europe in March 2023 noted:

“One of the challenges for all companies – be they reporters in the EU, the UK or other jurisdictions – is that boards are going to have to get much more disciplined and discerning about what is material in the context of this company, what do I need to report? In the UK, what we tend to have is Boards saying, ‘these four things are really important’, and then they hear feedback and someone says, But you must report on this, and you must report on this and you must add this in and you must add this in. And four things become 10 things. And then, rather than actually being focused on, how does this align with our business model? How does this align with us discharging our obligations to stakeholders? It all becomes more of a compliance exercise. And that’s what I desperately want to get away from.’ IR Magazine, March 2023

While companies will need to start considering the regulatory requirements specific to them, they will also need to consider the wider implications of increased stakeholder interest in areas which are material to their business. Companies will need to:

- Demonstrate clear leadership of the ESG programme at Board and Executive level.
- Assess materiality through the lens of the SASB standards, and focus business resources on the most material and significant issues.
- Ensure ESG data informs decision-making and strategy, not just compliance and reporting.
- Consider how to integrate the decarbonisation pathway into business strategy.
- Incorporate financial modelling and forecasting into TCFD and beyond.
- Work to better understand, assess and report on Scope 3 emissions.
- Prepare for limited or reasonable assurance as part of the audit process, to add validity to disclosures and meet certain legislative requirements.
- Develop engagement programmes with key stakeholders including employees, customers, and investors to position ESG ambitions, understand stakeholder requirements and encourage collaboration, where applicable.
- Start to consider and monitor dependencies and impacts of nature on the business.
- Consider and engage with the entire value chain to understand impacts and priorities, as well as relevance of impending legislation, and encourage cooperation towards shared goals.
- Continue to monitor the regulatory landscape and adapt accordingly.
- Prepare the necessary disclosures and internal information and data gathering systems well before it is time to make disclosures public.