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Multinationals Face Challenges as They Prepare To Comply With the EU's Sustainability Reporting Law

- As the deadlines approach for multinationals to make their first disclosures under the Corporate Sustainability Reporting Directive (CSRD), the EU's new sustainability reporting law, they are confronting the significant time and resources required to gather and analyze the required information, and to determine what is material enough that it must be disclosed.
- Many multinationals are choosing to report using the "artificial consolidation" method, reporting only for EU subsidiaries in a combined report.
- Penalties for non-compliance with the CSRD disclosure requirements are still unclear because those will be set country by country, and EU member states have been slow to implement the EU law into their national laws.

It has been over a year since the EU Corporate Sustainability Reporting Directive (CSRD) came into force. The first sustainability reports for companies based in the EU, covering the 2024 financial year, will be due in 2025. Many multinational companies, including those based in the U.S., will be required to report about their EU businesses in 2026 for the 2025 financial year. Preparations are well underway. Below are the key challenges and choices multinationals face in preparing these first CSRD sustainability reports.

1. Applying the 'Double Materiality' Threshold

Companies subject to the CSRD must report information necessary to understand both:

(a) the company's impacts on the environment and society (impact materiality) and

(b) how sustainability matters affect the company's own development, performance and position (financial materiality).

Sustainability reports must include information on impacts, risks and opportunities (IROs) that are deemed material in the company's own operations, as well as in its upstream and downstream value chain.

The CSRD reporting standards set criteria for assessing materiality, but not specific thresholds. Management teams and directors are required to exercise judgment to a very large extent. The initial assessment frequently leads to a very long list of IROs that do not actually meet the materiality thresholds. Management teams and boards then need to set appropriate qualitative and/or quantitative thresholds to assess materiality of each potentially relevant IRO.

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In practice, given the scale of many businesses, identifying truly material IROs is a time-consuming, expensive and burdensome exercise that requires extensive stakeholder engagement, due diligence, information-gathering and development of IRO scoring criteria.

Many companies have engaged large teams, both internal and external, to review each IRO that may be material and assess them against the double materiality threshold based on each business' particular circumstances. Because many multinationals are public companies, many already prepare sustainability reports and therefore have a "base case" for assessing the materiality of sustainability factors in their businesses. Multinational companies have generally found that preparing voluntary sustainability reports is a valuable exercise in applying the double materiality threshold for CSRD compliance.

2. Making Use of 'Artificial Consolidation'

The CSRD requires companies to include sustainability information in their annual reports. However, some exemptions are available. For example, until January 2030, EU subsidiaries of non-EU parents may be exempt from reporting separately if the largest EU entity in the global group prepares a sustainability report that "artificially consolidates" all EU subsidiaries that are required to comply with the CSRD.

In practice, many multinational companies have decided to rely on the "artificial consolidation" exemption because their EU subsidiaries sit in different corporate chains within the global corporate group. That makes individual or even EU corporate group consolidated reporting burdensome because it would require the production of multiple sustainability reports.

However, as this exemption will not be available after January 2030, management teams and boards should consider the alternatives and start building reporting capabilities for long-term compliance with the CSRD. In practice, because the CSRD will begin to apply to third-country companies from 2030 on a global basis and not just regarding with EU operations, management teams have already started to consider consolidated global reporting.

3. Interplay With the SEC Reporting Obligations

In March 2024, the Securities and Exchange Commission (SEC) adopted new rules mandating climate-related disclosures in public companies' annual filings and registration statements. (See our Spring 2024 article "Preparing Now for the SEC's New Climate Rules.") Although the SEC voluntarily stayed the effectiveness of the new rules until legal challenges to them are resolved, companies need to prepare for the possibility that some or all the rules will eventually come into effect. Early preparation for compliance with the new SEC rules

is particularly important for companies subject to the CSRD, as they will be required to make disclosures under competing standards.

Because of the stay and uncertainty about the final form of the SEC rules, U.S.-based companies caught by the CSRD have generally been unable to plan in detail for compliance with both regimes. But multinational companies are already taking steps to ensure that their existing SEC disclosures (including risk factors and information about legal proceedings) are consistent with the comprehensive information that will be disclosed under the CSRD. Any disclosures that appear false or misleading, or inconsistent with disclosures made in other jurisdictions, could lead to securities litigation, particularly in the U.S. (See our Summer 2023 article "The EU's New ESG Disclosure Rules Could Spark Securities Litigation in the US.") To reduce the risk of litigation, many U.S.-based multinational companies also intend to ensure that any public sustainability-linked information is capable of assurance by auditors.

4. Penalties and Liability for Non-Compliance With the CSRD

The penalties for non-compliance with the CSRD remain unclear because each EU state can set its own penalties when implementing the CSRD into national law.

Although member states were required to implement the CSRD into their national laws by July 6, 2024, the majority have missed this deadline. As of August 28, only eight out of 27 member states have done so. The delay in transposition has created legal uncertainty, as many companies are unable to ascertain the extent of their CSRD compliance obligations and the consequences of breaching them.

In the absence of implementing laws across several key jurisdictions, many companies are relying on the provisions of the CSRD while closely monitoring developments in member states where reporting obligations are anticipated regarding penalties and any "gold plating" requirements beyond the CSRD requirements that those countries choose to add.

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