According to the Federal Ministry of Justice, the Corporate Sustainability Reporting Directive (CSRD) will require around 13,200 companies to provide comprehensive reporting on sustainability aspects.

The CSRD and its upcoming implementation in Germany

A practical overview

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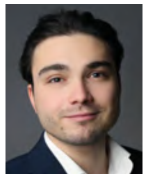
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On 24 July 2024, the German Federal Government approved a draft bill for the implementation of the so-called Corporate Sustainability Reporting Directive (CSRD) (Directive (EU) 2022/2464) into German law. The new law must still pass the German Bundestag and the Bundesrat before it can enter into force. This is only expected to occur only later this year, although the deadline for the EU Member States to implement the CSRD already expired on 6 July 2024. In terms of content, the regulations contained in the government draft largely represent a 1:1 implementation of the EU Directive.

Legislative process

In February 2020, the European Commission launched a public consultation on the revision of what is called the Non-Financial Reporting Directive (Directive 2014/95/EU, NFRD). Based on feedback and further analysis, the European Commission revised the NFRD, taking particular consideration of the European Green Deal. The result was the publication of the final version of the CSRD in the Official Journal of the European Union on 22 November 2022, which subsequently came into force on 5 January 2023.

The CSRD stipulates that national implementation should be completed by 6 July 2024 at the latest.

The legislative process in Germany began with the draft bill presented by the Federal Ministry of Justice (BMJ) on 22 March 2024 for a law to implement the CSRD. The BMJ had submitted the draft bill to the federal states, municipal umbrella organizations, certain specialist groups and affected associations and asked them to submit their comments by 19 April 2024. On 24 July 2024, the government draft on the implementation of the CSRD was published, as well as a synopsis comparing the current and proposed future regulations.

Germany failed to meet the implementation deadline for the CSRD, which is also true also for a large number of other EU Member States. However, a penalty in the form of infringement proceedings is fairly unlikely, as reporting on the 2024 financial year is not required until spring 2025. The new law can still take effect by then.

Goal of the CSRD

In terms of content, the CSRD provides for a reorientation of sustainability reporting in the EU. With the future reporting obligations, the EU wants to contribute to the transition to a fully sustainable and inclusive economic and financial system that is in line with the European Green Deal and the UN Sustainable Development Goals.

The aim is to provide publicly accessible and comparable information about the risks and opportunities of companies in connection with sustainability aspects, to direct financial flows toward sustainable economic activities (sustainable finance), and finally to achieve the transition to a sustainable and competitive economy.

Scope of application

Under the 2014 CSR Directive (Directive (EU) 2014/95), the requirements of the NFRD had been authoritative, and only large public interest companies with more than 500 employees were subject to the reporting obligation. In line with the requirements of the CSRD, the government draft provides for the abolition of the capital market conditions, among other things. As far as Germany is concerned, the CSRD now covers all companies that are generally large within the meaning of Section 267 of the German Commercial Code (Handelsgesetzbuch – HGB) (i.e., that meet two of the three criteria listed there). These criteria include (a) more than 250 employees, (b) a balance sheet total of more than €20 million and (c) sales revenues of more than €40 million. Also included are parent companies of a large group, capital market-oriented small and medium-sized corporations, and partnerships equivalent to these, with the exception of small companies; companies outside the EU whose securities are traded on an organized market in Germany, and companies outside the EU with net sales in the EU and other EEA Member States of at least €150 million in the last two financial years, and at least one large or capital market-oriented subsidiary or branch with net sales of at least €40 million in the EU (as well as certain small, medium-sized and large banks and insurance companies).

Initial application

In accordance with the CSRD, a staggered initial application applies for financial years beginning on or after 1 January 2024, as follows: (a) from 1 January 2024 to large companies and parent companies with more than 500 employees, (b) from 1 January 2025 to the other large companies and parent companies of a large group, (c) from 1 January 2026 to capital market-oriented small and medium-sized enterprises (SMEs), whereby the initial application can be postponed for two years via "opt-outs", as well as small and non-complex banks and captive insurance and reinsurance companies (captives), and (d) from 1 January 2028 to companies outside the EU according to the criteria already mentioned.

Possible exemptions

Under the German law that implemented the 2014 CSR Directive, it was already possible for subsidiaries to exempt themselves from sustainability reporting under certain conditions for both individual and consolidated reporting, if a parent company prepared consolidated financial statements and a group management report in accordance with EU law.

However, according to the government draft, it will no longer be possible for large capital market-oriented companies to exempt themselves from reporting in the future, even if a higher-level parent company publishes a corresponding consolidated report. Furthermore, if significant differences are identified in consolidated reporting between the risks or impacts of the group and those of a subsidiary, explanations must be included in the future to enable an understanding of the differences.

Subsidiaries of a non-EU parent company, on the other hand, should be able to exempt themselves if the consolidated reporting is in accordance with the European Sustainability Reporting Standards (ESRSs) or standards considered equivalent to the ESRSs.

Requirements for the sustainability reports

Under the new draft rules, companies will have to provide a brief description of their business models and strategies, a description of the timed sustainability targets, a description of the role of the management, supervisory or administrative bodies in connection with sustainability, a description of the company policy with regard to sustainability, as well as incentive schemes offered at management level.

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With regard to a company's impact on the environment and society, the sustainability report must report on sustainability aspects as part of a due diligence process, the most significant actual or potential negative impacts caused by company's own and related business activities, and any measures taken by the company to prevent or mitigate actual or potential negative impacts and the success of these measures.

Reporting on sustainability information is carried out in accordance with the ESRSs, which were developed by the European Financial Reporting Advisory Group (EFRAG), adopted as what are known as delegated acts by the European Commission on 31 July 2023, and then published in the Official Journal of the EU on 22 December 2023.

In addition to what is specified in the CSRD, the draft law stipulates that reporting obligations with regard to topics governed by other national regulations, such as the German Corporate Governance Code, remain unaffected.

Amendment of the Supply Chain Due Diligence Act

With the implementation of the CSRD, changes will also be made to the German Supply Chain Due Diligence Act (Lieferkettensorgfaltspflichtengesetz – LkSG). Duplicate reporting obligations will be avoided. The reporting obligations under the LkSG will be waived if a sustainability report is prepared and audited. The sustainability report must then be published on the company's website instead of the LkSG report and then submitted to the Federal Office of Economics and Export Control (BAFA). The government draft postpones until 31 December 2025 the obligation to submit the report for financial years beginning before 1 January 2024 (i.e., one year later). This applies regardless of whether companies continue to prepare an LkSG report or replace it with a sustainability report.

Location of sustainability reporting and tagging

In contrast to the NFRD, which gave Member States the right to choose the location of sustainability reporting, in accordance with the CSRD, the government draft requires that sustainability reporting must be included exclusively in the management report, in a section recognizable for this purpose, due to a lack of comparability between the various companies and sectors.

In accordance with the CSRD, digital financial reporting will henceforth be conducted via a platform for company data (European Single Access Point – ESEF). To ensure meaningful comparability with regard to the preparation of sustainability reports, this must be done using a specific (ESEF) format with corresponding tagging of the sustainability information. Due to the lack of regulation within the CSRD, the government draft provides for a postponement of the obligation to prepare the management report in ESEF format and mandatory tagging by two years to the 2026 financial year.

Auditing sustainability reports

Sustainability reports will ultimately be subject to mandatory auditing ultimately using the standard of "reasonable assurance", whereas "limited assurance" will be acceptable in the beginning. Details are still subject to a feasibility assessment that will be carried out by the European Commission by 1 October 2028. Until the European standards for the audit are issued, the audit standards recognized by the German legislator will apply.

For financial years beginning before 1 January 2025, the government draft contains a transitional provision on the appointment of the auditor if the auditor of the annual or consolidated financial statements has been appointed but no auditor of the sustainability report has been named. According to this provision, the appointed auditor will be deemed to be the auditor of the sustainability report by legal fiction, unless another auditor is appointed. The transitional provision is intended to prevent uncertainties that may apply during the first-time application for the 2024 financial year absent a definitive legal basis for the appointment of the auditor of the sustainability report.

Penalities

Although the CSRD calls on Member States to introduce effective, proportionate and dissuasive penalties for non-compliance, no specific penalties are mentioned in the EU Directive. In the German draft law, however, penalties have been specified and will be regulated either in the HGB (§ 334 HGB) or in the Introductory Act to the German Commercial Code (Einführungsgesetz zum Handelsgesetzbuch – EGHGB) or accompanying regulations.

Outlook

According to the BMJ, the CSRD will require around 13,200 companies to provide comprehensive reporting on sustainability aspects. The government draft published on 24 July 2024 calls for a 1:1 implementation of the Directive, if possible, with a few exceptions already mentioned. After the summer break, the government draft will be presented to the Bundestag and the Bundesrat. It is expected that the legislative process will be completed this year.

Despite the existing legal uncertainties and possible changes or additions with regard to the CSRD Implementation Act, it is recommended for all companies that will be obliged to report on sustainability – even if the first-time application is not planned until 2026 – are advized to familiarize themselves with the statutory obligations and the complex content requirements. ←