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Update on the EU Corporate Sustainability Reporting Directive (CSRD) for Japanese Companies

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Published on December 14, 2022, Directive (EU) 2022/2464 as regards corporate sustainability reporting (**CSRD**) imposes sustainability-related reporting obligations on entities satisfying certain criteria. "Sustainability-related matters" under CSRD refers to environmental, social and human rights and governance factors, including the sustainability factors listed in Regulation (EU) 2019/2088 (i.e., environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters). CSRD will enter into force on January 1, 2024, and certain entities will need to begin sustainability reporting as soon as 2025.

This article reviews entities to which CSRD will apply, outlines CSRD's requirements and discusses how it will impact Japanese companies at both the level of their European subsidiaries and at a group level.

1. Scope and application

Under Directive (EU) 2014/95 as regards disclosure of non-financial and diversity information by certain large companies and groups (**NFRD**) "public-interest entities"[1] with more than 500 employees are already required to include in their management reports non-financial statements with respect to, at a minimum, environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters. CSRD expands the scope of entities subject to non-financial reporting to progressively cover:

(1). Public-interest entities with more than 500 employees and public-interest entities which are parent companies of large groups with more than 500 employees for financial years starting on or after January 1, 2024 (sustainability reporting obligation begins in 2025);

(2). Large EU companies[2] and EU parent companies of large groups (other than public-interest entities) for financial years starting on or after January 1, 2025 (sustainability reporting obligation begins in 2026);

(3). For financial years starting on or after January 1, 2026 (sustainability reporting obligation begins in 2027), public-interest entities that are not

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[1] Public-interest entities are defined as (i) EU companies whose shares are traded on an EU market, (ii) credit institutions, (iii) insurance undertakings or (iv) entities designated as such by an EU member state.

[2] Large undertakings are undertakings which exceed at least two of the following three criteria: (i) a balance sheet total of EUR 20 million or more, (ii) a net turnover of EUR 40 million or more, and/or (iii) 250 employees or more.

are not micro-companies[3] but are (i) small[4] or medium-sized[5] companies (**SMEs**); (ii) SMEs qualifying as small and non-complex institutions under Regulation (EU) 575/2013; or (iii) SMEs which are captive insurance or reinsurance companies; and

(4). Non-EU groups with a net annual turnover of more than EUR 150 million in the EU and which have either (i) an EU subsidiary that is not a micro company whose shares are traded on an EU market or (ii) a branch located in the EU and governed by non-EU laws generating an annual turnover of EUR 40 million or more, for financial years starting on or after January 1, 2028 (sustainability reporting obligation begins on 2029).

Group parents will be able to publish group-level sustainability reports to avoid the need for each of their in-scope subsidiaries to publish its own sustainability report. EU subsidiaries or branches located in the EU and mentioned in (4) above will have to publish and make accessible a group-level sustainability report covering both their group's EU and non-EU entities.

2. Main requirements under CSRD

A. Sustainability reports: contents and format

CSRD expands on sustainability reporting requirements imposed under NFRD while ensuring better consistency with other sustainability-related EU laws and regulations, such as Regulation (EU) 2020/852 (often referred to as the EU Taxonomy). CSRD integrates the concept of double materiality, as in-scope companies are required to include in their management reports information necessary to explain (i) the company's impact on sustainability matters and (ii) how sustainability matters affect the company's development, performance and position, including descriptions of the following:

(a). The company’s business model and strategy with respect to sustainability;
(b). Time-bound targets related to sustainability matters set by the company;
(c). The roles of the administrative, management and supervisory bodies in sustainability matters;
(d). The company’s policies in relation to sustainability matters;
(e). Information about the existence of incentive schemes linked to sustainability matters which are offered to members of administrative, management and supervisory bodies;
(f). Sustainability-related due diligence performed by the company with regard to sustainability matters, including supply chain due diligence; and
(g). Principal risks faced by the company related to sustainability matters.

The description of sustainability-related due diligence mentioned in item (f) above will operate alongside the EU's proposed Corporate Sustainability Due Diligence Directive, which will impose further due diligence obligations and

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[3] Micro-undertakings are undertakings which do not exceed at least two of the following three criteria: (i) a balance sheet total of EUR 350,000, (ii) a net turnover of EUR 700,000, and/or (iii) 10 employees.
[4] Small undertakings are undertakings which do not exceed at least two of the following three criteria: (i) a balance sheet total of EUR 4 million, (ii) a net turnover of EUR 8 million, and/or (iii) 50 employees.
[5] Medium-sized undertakings are undertakings which do not exceed at least two of the following three criteria: (i) a balance sheet total of EUR 20 million, (ii) a net turnover of EUR 40 million, and/or (iii) 250 employees.

require companies to identify and prevent adverse environmental and human rights impacts in their value chains.

CSRD requires company sustainability reports to be drafted in accordance with detailed, comprehensive and sector-specific reporting standards (the so-called European Sustainability Reporting Standards; **ESRS**) and published in a digital format, thereby allowing for a better overview and comparison of companies' reported sustainability information. The European Financial Reporting Advisory Group (**EFRAG**) is currently finalizing the ESRSs so that the European Commission can promulgate them by way of a delegated regulation by June 30, 2024. The first draft ESRSs published by EFRAG were criticized by European supervisory agencies for being inconsistent with other existing sustainability reporting frameworks, such as those prepared by the International Sustainability Standards Board (**ISSB**). As such, while the final versions of the ESRSs may align more closely with other sustainability-related reporting standards, companies and groups falling under the scope of CSRD and already preparing sustainability reports using different standards will also have to prepare separate reports using the ESRS in order to comply with CSRD.

B. Sustainability assurance

Companies are required to seek a "limited" assurance opinion from a statutory auditor on the reported sustainability information in the management report. This opinion should gradually move to a reasonable assurance opinion, the latter being a more demanding assurance process. The European Commission envisages implementing standards for such reasonable assurance opinions before October 2028. CSRD requires safeguarding of the quality of the assurance of sustainability reporting and makes it subject to investigation and sanctions.

3. How can Japanese groups prepare to comply with CSRD?

EU subsidiaries satisfying the criteria set out in Section 1 above will have to comply with and report under CSRD. The first preparatory priority for Japanese groups with subsidiaries in the EU is to determine whether their subsidiaries will fall under the scope of CSRD, and if so, when they will have to start reporting under it. Ideally, this assessment should be initiated early to avoid non-compliance risks. Japanese groups with either (i) EU subsidiaries captured by CSRD or (ii) branches located in the EU with EUR 40 million in annual turnover will then have to calculate their group-level turnover in the EU. If this exceeds EUR 150 million, group-level CSRD reporting will be required.

It is recommended that in-scope companies and groups closely monitor the contents of the final versions of the ESRSs applicable to their respective sectors, including ways in which they may differ from existing sustainability reporting standards.

In addition, if subsidiaries are to prepare and report on sustainability reports that meet the disclosure requirements of CSRD, they should start preparing for a comprehensive CSRD compliance framework as soon as possible, including securing internal human resources capable of handling such reports and start considering whether part of such compliance work will need to be outsourced. Cross-functional collaboration within a company will be key to consolidate information on the company's major risks related to sustainability and the status of ESG due diligence implementation.

Furthermore, in order for subsidiaries in the EU to be exempted from the disclosure requirements under CSRD, their parent company in Japan may also need to implement sustainability disclosures that actually meet such CSRD requirements. In this case, Japanese listed companies that are obliged to submit annual securities reports, in particular, will have to compare and understand the differences between the revised "Cabinet Office Ordinance on Disclosure of Corporate Information, etc." (i.e. the applicable Japanese corporate disclosure framework) and the CSRD disclosure standards, and then implement sustainability report that can meet both disclosure requirements.

On March 16, 2023, the European Commission submitted a series of proposals including the launch of the Net Zero Industry Act (NZIA), and on March 22, 2023, the Commission submitted a Proposal for a Directive on Green Claims, which aims to prevent "Greenwashing". Japanese companies operating in the EU will need to take early action in anticipation of the implementation of various ESG-related regulations, including the CSRD. Details of the NZIA and the Proposal for the Directive on Green Claims will be introduced in subsequent Client Alerts.