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BRIEFING NOTE

EU sustainability reporting requirements:

Implications for Canadian business and policy makers

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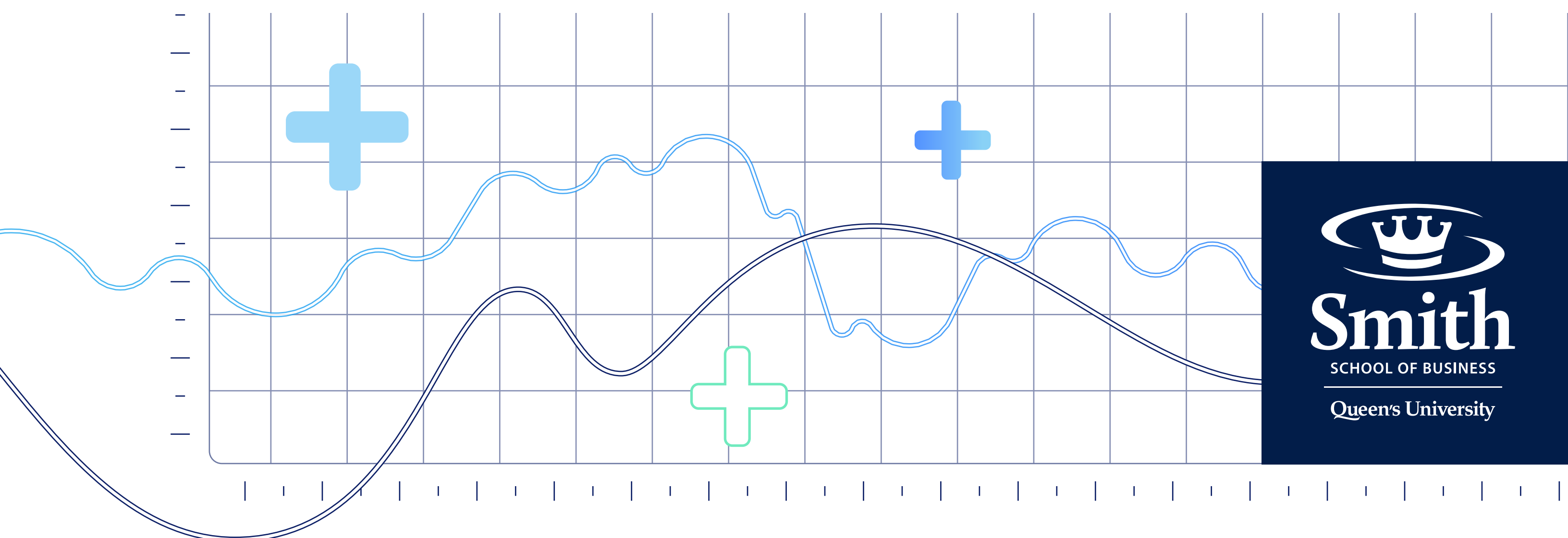
Authors

Yingzhi Tang
Senior Research Associate
Institute for Sustainable Finance
yingzhi.tang@queensu.ca

Simon Martin
Senior Research Associate
Institute for Sustainable Finance

Ryan Riordan
Director of Research
Institute for Sustainable Finance
ryan.riordan@queensu.ca



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EXECUTIVE SUMMARY

This brief examines how Canadian companies are impacted by the newly enforced Corporate Sustainability Reporting Directive (CSRD) and the accompanying European Sustainability Reporting Standards (ESRS) in the European Union (EU). The authors also aim to draw insights from the latest EU sustainable finance regulations and understand their implications on Canada's policy design, specifically, Canada's forthcoming green and transition finance taxonomy.

This article is structured as follows: it first reviews the latest updates in the global disclosure landscape; provides background on CSRD and its link to the broader EU sustainable finance framework, particularly, the EU Taxonomy; briefly summarizes the current state of Canadian companies' sustainability disclosures; concludes with lessons learned for Canada's sustainable finance journey, particularly for the taxonomy workstream at the Sustainable Finance Action Council (SFAC).

EIGHT TAKEAWAYS:

1. The Corporate Sustainability Reporting Directive (CSRD), even though a European legislative act, also affects non-EU companies (including Canadian ones) with listed securities or significant operations in the European Union (EU).
2. The primary objective of CSRD is to ensure that companies' sustainability information is disclosed in a relevant, comparable, consistent, reliable, and easy-to-access manner.
3. The CSRD takes a phased-in approach based on company sizes. The first set of companies subject to it are required to report for the financial year of 2024, with the first sustainability statement published in 2025. These are the companies previously subject to the Non-Financial Reporting Directive (NFRD) and other large and listed entities (equity or certain debt securities listed on an EU-regulated market) with more than 500 employees, regardless of whether they are an EU or a non-EU entity.
4. A total estimated number of 1,311 Canadian companies could potentially fall under the CSRD scope, with the Materials sector (of which 94% are from the Metals & Mining industry) topping the chart based on the number of companies being impacted.
5. Measuring the impact by revenue size (instead of the number of distinct corporate entities), the financial sector could potentially be the most impacted. This assumes reporting is done at a consolidated group level and uses 12 months of trailing revenue data as of December 2023.
6. Despite the alignment on major disclosure frameworks, such as the Task Force on Climate-Related Financial Disclosures (TCFD), Canadian companies might still fall short of the European Sustainability Reporting Standards (ESRS) required by the CSRD, particularly due to the inclusion of impact materiality on top of the financial materiality assessment ("double materiality" approach).
7. As part of the EU sustainable finance framework, the EU Taxonomy unifies the definition of "sustainable activities" for using such language in sustainability disclosures by companies subject to the CSRD.
8. Therefore, Canadian companies are not only facing additional compliance pressure from the CSRD and any other forthcoming sustainability regulations where Canadian companies operate, but also losing the opportunity to attract foreign capital (from institutional investors in the EU and other sustainability-conscious markets) without mandating a globally interoperable taxonomy and a standardized sustainability disclosure rule in Canada.

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This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for legal, financial or accounting advice.

DISCLOSURE LANDSCAPE

For decades, companies reported sustainability information, initially providing vague statements about climate initiatives and performance on self-selected environmental metrics. Over time, disclosures have become standardized, facilitating their use by investors, stakeholders, and interested parties.

As corporate climate disclosure evolves, companies worldwide have developed and adopted several guidelines and frameworks. These voluntary disclosure frameworks include the Sustainability Accounting Standards Board (SASB) standard and recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD). Given one of the goals of sustainability and climate disclosures is comparability, an issue emerged because there was not one standard that companies could use to satisfy stakeholder demands. Further, companies sometimes report climate information under more than one reporting framework, which increases reporting costs.

To bring a more unified approach to this fragmented market, the International Sustainability Standards Board (ISSB) released two standards. The first, the International Financial Reporting Standards (IFRS) S1, "provides a set of disclosure requirements designed to enable companies to communicate to investors about the sustainability-related risks and opportunities they face over the short, medium and long term." The second standard, IFRS S2, covers specific climate-related disclosures and is meant to be used with IFRS S1. Importantly, these standards also fully incorporate the TCFD recommendations.

However, the ISSB lacks regulatory authority, relying on jurisdictions with regulatory control to adopt the standards, either partially or entirely. This underscores the pivotal role of the Corporate Sustainability Reporting Directive (CSRD) and the accompanying European Sustainability Reporting Standards (ESRS) that were recently adopted by the European Union.

WHAT IS THE CSRD?

The Corporate Sustainability Reporting Directive (CSRD) is one of the key pillars of the EU sustainable finance framework, together with the EU Taxonomy Regulation, the Sustainable Finance Disclosure Regulation (SFDR), and the European Green Bond Regulation.

The CSRD entered into force on January 5, 2023, as a replacement for the Non-Financial Reporting Directive (NFRD) and will require companies under the CSRD scope (see Table 1) to report on sustainability in a standardized way that enables investors and civil society actors, among other stakeholders, to identify and assess potential risks and opportunities. The primary objective of CSRD is to ensure that companies' sustainability information is disclosed in a relevant, comparable, consistent, reliable, and easy-to-access manner.

The 12 European Sustainability Reporting Standards (ESRS) provide overarching and topical requirements and guidance on sustainability disclosures. Within the 12 ESRS, ESRS 1 and ESRS 2 set out general principles and essential information, respectively, for all companies subject to CSRD.

One of the major requirements from CSRD and ESRS is the financial and impact materiality assessment (known as the "double materiality" approach), the latter of which is often overlooked by other sustainability disclosure regulations and standards (e.g., SASB, ISSB). In other words, companies subject to CSRD are required to report both on their impacts on the environment and society, as well as how social and environmental issues impact their financial performance.

Regarding the scope, CSRD applies to all large and listed companies (including listed small and medium-sized companies "SMEs" except for micro-enterprises)[1] in the EU. "Large undertakings" are defined as those on a consolidated basis exceeding at least two of the following three criteria on two consecutive annual balance sheet dates[2]: EUR 25 million balance sheet total; EUR 50 million net turnover; or 250 average number of employees. Importantly, although the CSRD is a European legislative act, it also affects non-EU companies with listed securities or significant operations in the EU. The CSRD states companies in scope will have to begin reporting under ESRS (which outlines what information companies need to report to EU regulators to comply with the CSRD) according to the following timetable (see **Table 1**).

TABLE 1

Companies in scope and required timeline

When to disclose?	Who are required to disclose?
Financial year 2024, with first sustainability statement published in 2025	Companies previously subject to the Non-Financial Reporting Directive (NFRD) (large, listed companies, large banks and large insurance undertakings — all if they have more than 500 employees) And Large non-EU listed (equity or certain debt securities listed on an EU-regulated market) companies with more than 500 employees
Financial year 2025, with first sustainability statement published in 2026	Other large undertakings including other large non-EU listed entities
Financial year 2026, with first sustainability statements published in 2027[3]	Listed SMEs, including non-EU listed SMEs
Financial year 2028, with first sustainability statement published in 2029[4]	Additional consolidated group-level reporting is required for: Non-EU companies that generate over EUR 150 million per year in the EU; and that have in the EU either a branch with a turnover exceeding EUR 40 million or a subsidiary that is a large undertaking or a listed SME

Source: European Commission, 2023. "Questions and Answers on the Adoption of European Sustainability Reporting Standards."

Note: On February 7, 2024, EU lawmakers agreed on a two-year delay to June 2026 (originally June 2024) for the adoption of sector-specific disclosure standards as well as standards for specific third-country (i.e., non-EU) companies. It is intended to give companies more time to focus on the implementation of the first set of cross-cutting and sector-agnostic European Sustainability Reporting Standards (ESRS).

Non-EU companies are required to report at a consolidated level starting from the financial year 2028. This schedule remains unchanged.

1 Large, small and medium-sized, micro-companies (or "undertakings") are defined in accordance with Article 3 of Directive 2013/34/EU. In response to significant inflation during 2021 and 2022 the monetary size criteria was updated.
2 Article 3, paragraph 10 of Directive 2013/34/EU.
3 However, listed SMEs may decide to opt out of the reporting requirements for a further two years. The last possible date for a listed SME to start reporting is financial year 2028, with first sustainability statement published in 2029.
4 Separate standards will be adopted specifically for this case.

THE LINK TO THE EU TAXONOMY

The EU Taxonomy, entered into force on July 12, 2020, is a classification system that provides a common language and clear definition for sustainable economic activities. To be eligible as “taxonomy-aligned”, the economic activity must (a) make a substantial contribution to at least one of the six environmental objectives such as climate adaptation and mitigation, pollution prevention, and biodiversity protection[5]; (b) do no significant harm to any of the other environmental objectives; (c) meet minimum social safeguards.

The ESRS also requires disclosures following Article 8 of the EU Taxonomy Regulation, for example:

- The proportion of their turnover derived from products or services associated with taxonomy-aligned activities.
- The proportion of capital expenditure (CapEx) and operating expenditure (OpEx) associated with taxonomy-aligned activities.

Essentially, the EU Taxonomy unifies the definition of “sustainable activities” for using such language and concepts in sustainability disclosures by companies subject to the CSRD. In doing so, investors and other stakeholders can benefit from better clarity on companies’ climate-related risks and transition plans while lowering greenwashing risk exposures.

HOW DOES THE CSRD AFFECT CANADIAN COMPANIES?

To examine how the CSRD affects Canadian companies we began with the set of Canadian companies identified by a June 2023 Refinitiv analysis. We then use data from Bloomberg to add several variables to the dataset including revenue and several levels of classification (sector, industry group, industry, sub-industry).[6]

A total number of 1,311 Canadian companies are impacted, according to the Refinitiv analysis. The set of Canadian companies spans several industries, with the Materials sector[7] being the most common by far (577 firms). Within the Materials sector, 94% are from the Metals & Mining industry. The remainder is from Chemicals, Forestry, Paper & Wood Products, Containers & Packaging, and Steel (see Figure 1 & Figure 2). The second most common group is Consumer Staples, of which 71% is Tobacco & Cannabis, followed by Food (14%), Retail (7%), Beverages (4%), Wholesale (3%) and Household Products (1%). Figure 1 below highlights this and shows the number of companies for each other sector.

5 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.

6 Data was pulled December 2023. Revenue is annualized over the latest 12 months of data.

7 We used the Bloomberg Industry Classification Standard (BICS) to describe the sectoral breakdown.

FIGURE 1

Canadian companies affected by CSRD grouped by sector (ranked by numbers of companies in each sector)

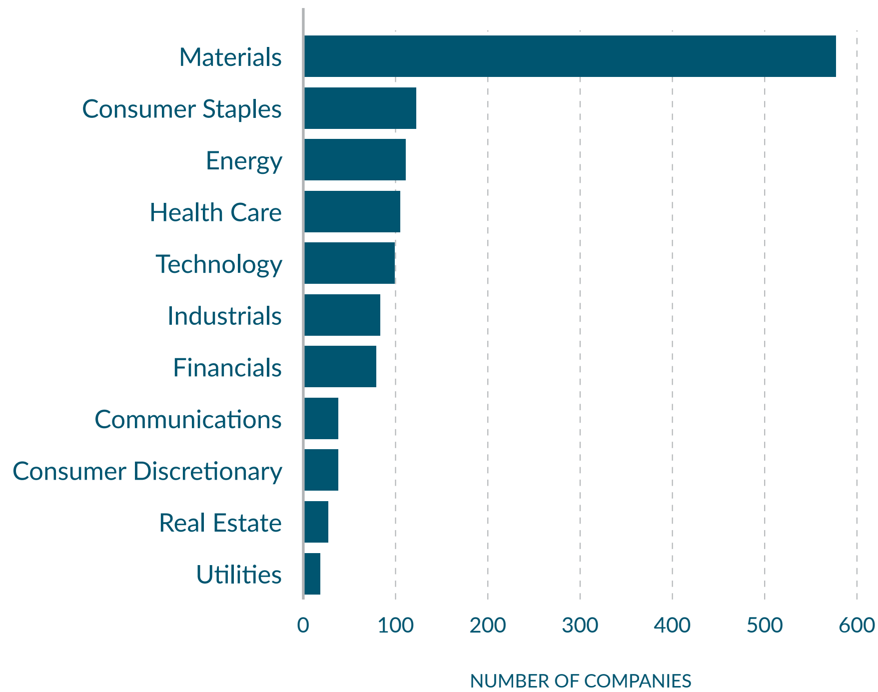
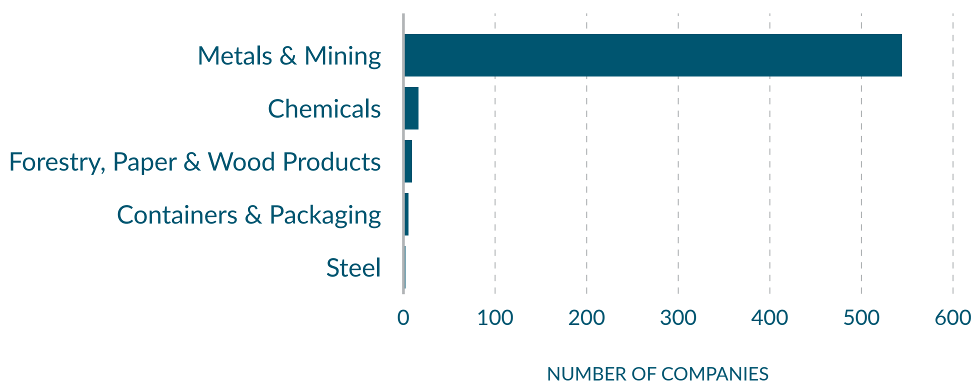


FIGURE 2

Materials sector broken down into industry

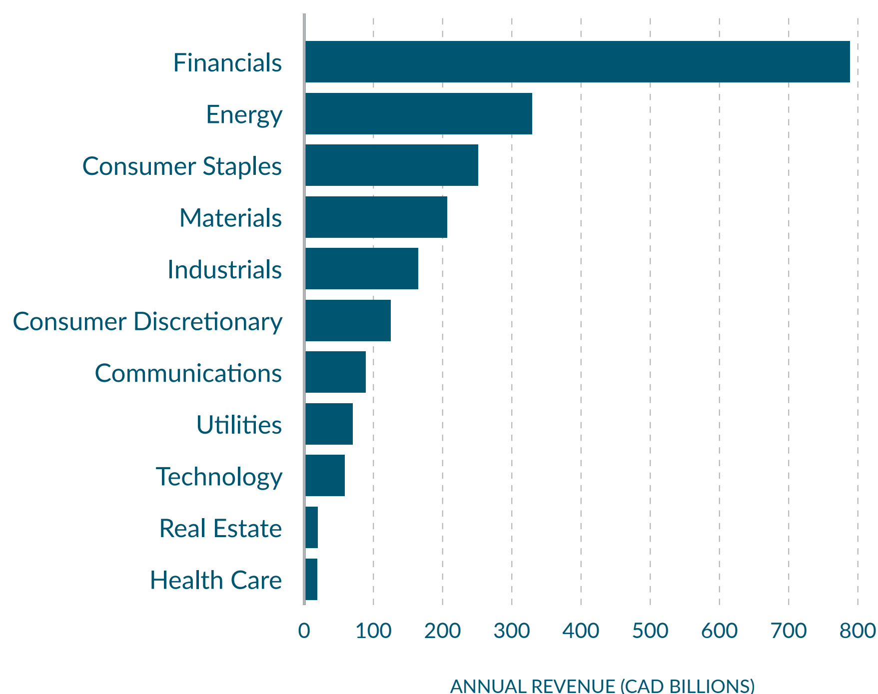


Canadian companies in scope can choose to report solely for their EU-based subsidiaries or at a consolidated global level up until the financial year of 2028. Starting in the year 2028, a consolidated report is required for certain non-EU entities. The requirements under ESRS are substantial and in some cases will require gathering information across several departments located in multiple countries. This can create issues, especially when done at the consolidated global level, for companies that do not already have the capacity or systems in place to meet this need.

As noted in the last row of Table 1, starting in fiscal year 2028, certain non-EU parent companies may be subject to reporting at the group level. This will not necessarily apply to all companies identified in Figure 1. However, for the sake of illustration, if we assume that all affected companies report globally and if we measure the impact of CSRD on companies using company revenue, then the Financials sector stands out as the most significantly affected (see **Figure 3**). It is worth noting that the financial sector's reporting largely depends on the information being disclosed by their borrowers. Therefore, the CSRD pressure on financial companies (e.g., banks, insurers, and asset managers) can have a downstream effect on the real economy.

FIGURE 3

Canadian companies affected by CSRD grouped by sector (ranked by annual revenues)



The direct financial or legal costs of CSRD non-compliance are not currently clear as each EU member state has been given flexibility on penalties applied. For example, CSRD states with respect to audits and assurance that, "Member States shall ensure that there are effective systems of investigations and sanctions to detect, correct and prevent inadequate execution of the statutory audit and the assurance of sustainability reporting."

Non-compliance with CSRD can result in direct penalties and additional costs such as reputational damage and financial repercussions. Companies failing to adhere to sustainability reporting regulations risk losing investor confidence, potentially reducing access to capital.

A BRIEF ON THE STATE OF CANADIAN CORPORATE DISCLOSURES

The ISF's previous research on corporate GHG emissions and target-setting disclosures found that 72% of the S&P/TSX Index constituents disclosed emissions data and 57% had at least one type of GHG reduction target. Although this set of companies does not exactly match the ones impacted by CSRD, it still provides us with a useful indication of Canadian companies' readiness and climate disclosure status. We also find that approximately 54% of the companies in the Index report roughly in alignment with TCFD. This alignment is a good start for companies as ESRS requirements incorporate TCFD recommendations. However, the scopes of ESRS surpass TCFD, underscoring the need for Canadian companies to prepare for additional assessments in order to achieve the granularity and rigour required by EU lawmakers.

In terms of disclosures on capital allocation alignment, a focus area within CSRD/ESRS, the 2023 Climate Engagement Canada (CEC) Net Zero Benchmark assessment shows that none of the CEC's focus list companies[8] backed their decarbonization targets by related CapEx disclosures. Compared to the global landscape, roughly 43% of Climate Action 100+ focus companies have at least partial information on such capital allocation. The significant gap shows that Canadian companies' current disclosure practices fail to match up to the CSRD's expectations.

Additionally, on assurance requirements, the CSRD states that sustainability reports should be accompanied by an assurance opinion, and if such an opinion is not provided, a statement indicating its absence should be issued. To quantify the financial impact of this, an ERM study found that the annual spend for US companies' climate disclosure assurance/audits in 2020 or 2021 is US$ 82,000 (which for some companies makes up part of the average annual US$ 677,000 that American companies spend on climate-related disclosure activities).

Our research highlights that only 37% of Canadian companies in the S&P/TSX index, based on their sustainability reports published in 2022, had their emissions verified by a third party.[9] Compared to the CSRD/ESRS requirements for assurance over the full sustainability report (which contains a large number of key performance indicators in addition to emissions), a significant amount of work has to be done by Canadian companies in scope to catch up with the CSRD/ESRS requirements on the assurance front.

IMPLICATIONS ON CANADA'S SUSTAINABLE FINANCE JOURNEY

In support of achieving a net-zero economy by 2050, in May 2021, the Government of Canada launched the Sustainable Finance Action Council (SFAC) to make recommendations on critical market infrastructure needed to attract and scale sustainable finance in Canada. Within SFAC, there are three technical expert groups and one working group. SFAC states that the objectives of these four groups are:

- **Disclosure (Lead: Barbara Hooper, TD Bank):** Support efforts to introduce mandatory Task Force on Climate-Related Financial Disclosures (TCFD)-aligned climate disclosures in Canada, to achieve broad coverage across the economy.
- **Taxonomy (Lead: Barb Zvan, UPP Investments):** Outline needs amongst market participants to define green and transition investments and activities within the context of Canada's capital markets.
- **Data (Lead: Louis Marcotte, Intact Financial):** Validate and advise on climate data needs and capacity within the financial sector.
- **Net Zero Capital Allocation Working Group (Co-Leads: Dan Barclay, BMO, and Evan Siddall, AIMCO):** Provide recommendations to address challenges in directing private capital to net-zero solutions."

Source: Government of Canada. "Sustainable Finance Action Council."

8 CEC's Focus List companies have been identified as the top reporting or estimated emitters on the Toronto Stock Exchange (TSX) and/or with a significant opportunity to contribute to the transition to a low-carbon future and become a sectoral and corporate climate action leader in Canada.
9 The results are based on information included in corporate reports released during 2022, augmented with data reported to CDP (formerly the Carbon Disclosure Project).

SFAC's focus areas also take note of international best practices such as the EU sustainable finance framework.

Among the three technical expert groups, SFAC has prioritized the taxonomy workstream to accelerate private capital mobilization toward sustainable and low-carbon investment in Canada.

In March 2023, the SFAC released its Taxonomy Roadmap Report which outlines a framework to guide the development of a Canadian Green and Transition Finance Taxonomy. The Canadian taxonomy under development is promised to both reflect Canada's economic context and facilitate cross-border interoperability. Importantly, the Roadmap Report proposes an initial framework for identifying "green" and "transition" activities under two separate categories.[10]

Meanwhile, despite the increasing voluntary sustainability disclosures in Canada, investors are still concerned about greenwashing risks and access to high-quality data due to the lack of standardized reporting rules similar to the CSRD.

Some earlier efforts have been made to harmonize sustainability reporting in Canada. For example, the Canadian Sustainability Standards Board (CSSB) has been working with the International Sustainability Standards Board (ISSB) to support the uptake of ISSB standards in Canada, and in March 2024 released draft Canadian standards for public consultations.

However, without a functional made-in-Canada taxonomy to serve as the backbone, standardized disclosures alone are unable to communicate the unified understanding of "green" and "transition".

This means that Canadian companies are not only facing additional compliance pressure from the CSRD and any other forthcoming sustainability regulations where Canadian companies operate but also losing the opportunity to attract foreign capital from institutional investors in the EU and other sustainability-conscious markets.

In particular, Canadian companies with "green" and "transition" activities in need of capital support might struggle to mobilize private finance at scale in Canada and more importantly, internationally, for example, through issuing financial instruments (e.g., green and transition bonds) with underlying taxonomy-aligned activities.

Regarding capital mobilization in global capital markets, a comparable and interoperable Canadian taxonomy can lower transaction and compliance costs, while increasing investor confidence across borders. Globally, major economies such as the EU and China, whose sustainable taxonomies are both pioneering but designed differently, are comparing, and identifying commonalities and differences between their approaches. It is important for Canadian green and transition taxonomies to be interoperable with leading international science-based taxonomies, such as the EU Taxonomy, to instill market confidence and reduce costs for issuers and investors.

In summary, the taxonomy will be a centrepiece of sustainable finance development in Canada. Any delays in formulating a credible and science-based taxonomy accompanied by necessary disclosure standards or regulations will put Canadian companies at risk of being unprepared and disadvantaged amidst the inevitable, low-carbon transition happening around the globe.

10 To learn more, read ISF's Taxonomies Briefing Note.