Initial Reaction of the ASCG on the Working Papers of EFRAG's Project Task Force on European Sustainability Reporting Standards (PTF-ESRS)

The European Commission (COM), in the letter dated 12 May 2021, has asked EFRAG to develop draft sustainability reporting standards consistent with the requirements set out in the CSRD proposal as of 21 April 2021. On 20 January 2022 EFRAG's Project Task Force on European Sustainability Reporting Standards (PTF-ESRS) has published the first batch of Working Papers (WP).

We would like to express our gratitude for the substantial work that the PTF-ESRS has accomplished, and we acknowledge the achievement of developing the WP on conceptual guidelines, cross-cutting issues, and climate-change in a short period of time. We appreciate this work of many experts as an important step towards high-quality, widely accepted ESRS. In the Cover Note the PTF-ESRS lays out that the WP provide information on the conceptual thinking adopted in the draft standards. While we acknowledge that it is a work-in-progress document we appreciate that EFRAG ensures transparency and would like to share our initial observations regarding the conceptual basis and the direction the proposals are taken. Due to the timeline restrictions, which imply handing over the first set of draft standards to the COM by 15 June 2022, we believe it to be essential to address these observations in a timely manner.

In general, we would like to confirm our key messages regarding sustainability reporting standards as proposed in the CSRD which were laid out in our catalogue of "Critical Success Factors" for future EFRAG standard setting in the area of sustainability reporting of 29 November 2021. We identified critical aspects such as the need for prioritisation of reporting topics, consideration of a "global baseline" and proportionality of reporting requirements. An analysis of the first batch shows these observations are still valid.

GLOBAL BASELINE: ESRS need a clear international orientation and compatibility

The consideration of a global baseline in our view remains one of the crucial issues. Sustainability matters address global concerns. Therefore, it is necessary that EFRAG follows a global baseline approach with special consideration paid to the current work by the International Sustainability Standards Board (ISSB). While ESRS follows a double materiality approach and need to consider requirements specific to the EU (e.g. Sustainable Finance Disclosure Regulation), the ESRS's requirements should nevertheless aim at being compatible with ISSB's global baseline. The ESRS should then highlight and justify necessary extensions. This building-block-approach will allow for a level-playing field for preparers, comparability, and decision-usefulness of sustainability information, as well as acceptance of ESRS worldwide. We therefore encourage EFRAG to lay out the analysis on compatibility and include for comment its conclusion regarding the compatibility with ongoing work on ISSB's standards in terms of substance as well as terminology.

In this context we have noted that the Basis for conclusions of the WP on climate change (ESRS E1) already addresses compatibility of ESRS E1 and the Technical Readiness Working Group (TRWG) Climate-related Disclosures Prototype. We observe that the PTF-ESRS has flagged as "compatible" almost all of the requirements proposed in ESRS E1; however, it should be noted that these are much more granular, and numerous compared to the TRWG paper. A compatible reporting approach should keep additional or more granular requirements at a necessary minimum.

PRIORITISATION and PROPORTIONALITY: Extent and Complexity of the Reporting Requirements reduces feasibility of proper implementation – field tests could enhance applicability and acceptance

Furthermore, the extent and complexity of the requirements laid out in the WP do not yet provide a sufficient prioritisation or degree of proportionality of sustainability information. Given the scope extension inherent in the CSRD proposal the ESRS will need to be implemented not only by large capital market-oriented entities but also by entities with significantly less administrative resources. In Germany alone the scope of entities addressed by the CSRD will increase from about 500 reporting entities to approx. 15,000 entities. These first-time reporting entities will at the same time be first-time preparers of electronic format information, including the application of the EU-Taxonomy-Regulation. But not only with these challenges in mind are the requirements in the current WP overly extensive and detailed. Even large entities with experience in sustainability reporting find it difficult to comply with the ESRS within the short time provided by in the CSRD proposal as of April 2021. The implementation and, therefore, the quality of information reported will most likely fundamentally vary across entities, thereby limiting comparability.

Instead of the rule-based approach currently apparent in the WP we recommend a more principle-based standard setting approach. This gives reporting entities proper flexibility to provide information according to the needs of their stakeholders. Our reasoning is based on the view that an entity's management has got significant knowledge about the composition of the entities' stakeholders and the information they require. In our view standard setting should generally give preference to concise reporting standards over granular reporting requirements.

An example for extensive disclosure requirements is WP ESRS E1 on climate change. We note that it comprises 23 disclosure requirements (DR, excl. the reference made to the disclosures according to Art. 8 of the EU-Taxonomy-Regulation). However, these DR are further detailed in the WP, eventually resulting in more than 100 single disclosures. These are, in addition, significantly expanded through extensive requirements set out in the Application Guidance (AG).

Both, topical and cross-cutting standards lay out detailed disclosure requirements in the standard text and the accompanying AG, the latter often substantially extending the requirements. Moreover, the requirements often comprise to the whole value chain, potentially including the up- and downstream value chain of the entity as well as the value chains of suppliers, sub-contractors, and customers (see WP ESRS 2 AG13 et seq.). The complexity of gathering and preparing this information is likely to be too big a burden, not only for first-time reporting entities. Reporting entities will have to gather information not only from large suppliers or customers, but from numerous SMEs along the value chain who might not be able to provide the data (or the data quality) needed. This could impair the quality and, therefore, the comparability of sustainability information of reporting entities.

A further example for overly burdensome requirements is a concept in WP ESRS 4 which asks entities to not only disclose material information but to also state non-material disclosures and the evidence for this assessment. The emphasis on non-material information, including the disclosure of explanations, – as required in par. 10 – should be questioned in terms of its benefits for users and stakeholders. In our opinion, long lists of non-material information are not meaningful and cause unnecessary costs. The ESRS should clarify the level at which these non-material considerations are required (e.g., rather topic or sub-topic, but not at the level of a single disclosure requirement).

As an example, we would like to point to DR2 of WP ESRS E1. It requires information on the resilience of the strategy and business model(s) of the undertaking to principal climate-related transition and physical risks. Such an analysis would require data from numerous suppliers and customers (for large groups often exceeding 50.000), which are in practise prioritised for reasons of feasibility, as a complete coverage would not be proportionate to the benefits. Therefore, risk-oriented approaches for identifying key suppliers (Tier 1, Tier 2, etc.) have already been established in practice and are also accepted for sustainability reporting. Activities in the value chain that are less relevant for a resilience analysis would not be considered, but this would have to be stated and justified within the statement of non-material aspects as required by ESRS 4. Another layer of complexity is created with the use of climate scenarios as proposed in WP ESRS E1 (e.g., DR5). Even though this aspect is much promoted by the Task force on Climate-related Financial Disclosures, the use of climate scenarios to assess climate related physical and transition risks and opportunities by entities is not very widespread yet, even among large entities with experience in sustainability reporting. Since many requirements in WP ESRS E1 refer to such scenarios we think the gap between these requirements and the information that entities can meaningfully provide will increase with this level of complexity.

Notably, the above observations relate only to the currently published WP. With many more documents to come (on Guidelines, cross-cutting- and topical standards) and additional various sector-specific standards we are afraid that entities will face considerable implementation challenges and costs. We refer to the experience of introducing IAS/IFRS in Europe, while this only included capital market-oriented entities that usually had accounting knowledge and capacities corresponding to the challenges.

In our view, a phase-in-period could be considered to allow for a smooth transition in sustainability reporting as relevant processes and the control environment are likely to develop gradually. Such a phase-in approach could be two-fold comprising a scope phase-in and a content phase-in. For one, a phase-in-period could allow for larger entities to apply ESRS first and include their own operations first. The reporting requirements would be extended to SME reporting entities and SMEs along the value chain in a second phase (*scope phase-in*). In addition, the phase-in-period could allow for a prioritisation of sustainability matters required to be reported on (*content phase-in*). This would be consistent with the COM's approach in the context of the EU-Taxonomy-Regulation which focuses on two environmental goals, climate change mitigation and climate change adaption. We believe a comparable phase-in approach to the application of reporting standards on other sustainability issues should be considered by focusing on SFDR relevant data and climate as a matter of the highest priority.

To allow for a high-quality implementation of ESRS, we ask both, EFRAG and COM, to reconsider the aforementioned scope extension of the reporting requirements according to the CSRD proposal as well as the timeline intended. An extension of the timeline would also provide an opportunity to enhance the quality of the ESRS itself. This process could include a field test phase, in which trial runs on preparing the sustainability reporting information are conducted. This would clarify the understanding of the (number, detail of) information required in the ESRS, the challenges faced to provide this information, and the actual reporting outcome in terms of quality as well as volume of the sustainability information required in the ESRS. The current challenges of implementing the Taxonomy Regulation confirm the need for careful consideration of possible implementation issues. This will foster a consistent application of the ESRS across entities and therefore increase the quality of sustainability reporting and acceptance of ESRS.

CONNECTIVITY: connectivity between financial and sustainability information is currently limited

Last but not least we would like to emphasize the need to enhance the connectivity between financial and sustainability information. The CSRD proposal promotes the connectivity between, and consistency of, financial and sustainability information, which is particularly important for users and stakeholders of sustainability reporting. According to the proposal the standards should promote an integrated view of sustainability and financial information which we believe is also essential for the acceptance and usefulness of ESRS. In this context we note that the current debate on the need for a separate sustainability report is rather counterproductive as it contradicts the integration of sustainable and financial information and thereby unnecessarily limits the connectivity. We acknowledge that the PTF-ESRS are still working on further improving the financial connectivity. However, we would like to emphasize some aspects below to improve connectivity and integration.

While the ESRS use a terminology that suggests a consistency with financial reporting there is often a different understanding of these terms. The most prominent example is the materiality concept. According to the ESRS (ESRG 1, ESRS 4) both, the standard setter and the entities identify *material* information. In contrast to this understanding, in some financial reporting frameworks a standard setter (e.g., IASB) first identifies the set of *relevant* information for which the requirements are laid out in the standards (e.g., IFRS). This assessment is based on relevant stakeholders and their information needs. In a second step, based on the set of relevant information (defined by the standard setter), the entities identify the subset of *material* information. Materiality is therefore an entity-specific aspect of relevance. In line with this understanding WP ESRS 4 requires entities to determine material information from their perspective, establishing their specific thresholds/criteria for classifying a certain information as material or non-material. Different from this financial reporting understanding of materiality the ESRG 1 also asks the standard setter to perform a materiality – instead of a relevance – assessment based on the relevant stakeholders (as identified in ESRS) and their information needs.

Under ESRS the materiality concept includes a double materiality perspective with a financial materiality as well as an impact materiality. The ESRS explicitly exclude from a financial materiality in the context of sustainability reporting the financial effects captured in financial reporting. Since these financial effects are both supposed to likely influence the future cash flows and therefore the enterprise value of the entities this differentiation seems artificial. In addition, it does not provide for an integrative approach to sustainability and financial reporting. Therefore, the understanding of financial materiality in ESRS should be compatible with the current understanding in financial reporting.

The concept of double materiality which underlies not only the CSRD but also the ESRS is without doubt a vital part of sustainability reporting and essential for entities to determine material information. While it is essential to consider impacts as well as risks and opportunities when determining relevant and material information it is nevertheless questionable whether there is a need for the materiality assessment processes to be performed by the standard setter as laid out in ESRG 1 (guidelines 8 and 9). This process to be performed by standard setters seems to provide an unfounded sense of quantifiability of materiality and to result in impracticable process specifications. In addition, this unnecessarily creates confusion about the materiality concept. In our understanding a generic materiality assessment process as laid out in WP ESRG 1 is not needed; especially in the light of existing regulation (CSRD proposal and others) which provide a frame for the sustainability information to be provided.

To increase connectivity between sustainable and financial information the financial information already provided as well as links to financial information could be explored in more depth. For example, WP ESRS 2 in its standard text as well as in the AG requires various, very detailed turnover disclosures. Options should be explored as to how WP ESRS 2 could refer to relevant disclosures already available in financial reporting (e.g., IFRS 8, IFRS 15, IAS 1.13 with MC) thereby increasing the link to financial information. These could be enhanced in WP ESRS 2 by sustainability specific information such as the share of sustainable turnover. To connect the information the sustainability reporting could reference to amounts presented on the face of the primary financial statements or the management report outside. A comparable approach is proposed in several requirements of ESRS E1, for example in DR12 on GHG intensity.