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Draft EFRAG Implementation Guidance – IG 1 Materiality Assessment, IG 2 Value Chain

Dear Patrick

On behalf of the Accounting Standards Committee of Germany (Deutsches Rechnungslegungs Standards Committee, DRSC) I would like to thank you for the opportunity to comment on the aforementioned Draft Implementation Guidance documents. Please find in the appendix to this letter our feedback, approved by the majority of the DRSC's Sustainability Reporting Technical Committee, which mirrors the comments we submitted via the web-based surveys provided by EFRAG for this consultation.

In case you wish to discuss these issues further, please do not hesitate to contact Thomas Schmotz or myself.

Kind regards

Georg Lanfermann

President

APPENDIX

General comments on the Draft Implementation Guidance (posted in the box "Summary" in MAIG Feedback)

Given the fact that approximately 50,000 undertakings in the EU (thereof 15,000 in Germany, approximately) are required to prepare sustainability reports according to ESRS in the near future, the DRSC considers EFRAG's implementation guidance to be important and helpful for preparers in order to overcome the challenges resulting from numerous disclosure requirements that have to be met within a very short period of time. For the same reasons, the DRSC welcomes that EFRAG has established a mechanism to take account of practitioners' questions through the ESRS Q&A Platform. However, we notice that ESRS Set 1 was developed under high time and content pressure resulting in a number of inconsistencies and ambiguous requirements, which is evident, for example, from the high number of questions submitted via the ESRS Q&A Platform. For example, the DRSC notes that various terms are used to circumscribe different levels of what constitutes a specific subject of reporting. Specifically, the terms "undertaking", "site", and "facility" are used in different occasions. Furthermore, these terms are put into the context of operational and financial control; hence, from a preparer's perspective it is vital to understand these terms and their interaction. However, the glossary is silent on what the term "facility" means.

The DRSC argues that, to a certain extent, Implementation Guidance might help to mitigate such issues; however, most of these call for further standard setting activities such as clarifications (e.g., "What is a facility?") and amendments to ESRS.

Regarding the design of the consultation process, we would like to point out that both the timing and duration could hardly be worse chosen. In view of the current phase where most undertakings are preparing their reports and given the voluminous nature of the Draft Implementation Guidance documents, a consultation period of one month (after "neutralising" the year-end holiday season) seems inappropriate to us. EFRAG should urgently consider this for future consultations.

Comments on Draft IG 1: Materiality Assessment (MAIG)

General remarks (posted in box "Chapter 1: Introduction")

The DRSC believes that, due to a lack of experience with statutory and standardised sustainability reporting, impact materiality assessments will depend much more on individual judgement than the assessment of materiality for financial reporting, at least in the first years of ESRS application. The ESRS take this into account as they require undertakings to describe their materiality assessment process (as opposed to financial reporting standards which do not impose such an obligation) in order to enable users/readers of sustainability information to put the sustainability disclosures into the context of the underlying individual materiality assessment. We understand that the MAIG aims at helping undertakings in implementing materiality assessment processes, also to foster consistent application and to address the issue of subjectivity.

However, the DRSC does not believe that the MAIG will mitigate subjectivity in assessing materiality of impacts to a great extent. As an example: Chapter 3 of MAIG contains guidance on assessing the materiality of actual impacts and presents an example on classifying impacts' severity into a range of five values, from low to high. This example suggests that severity and all the underlying factors (hence, impact materiality) is consistently scalable. However, we believe that each of the components (1) scalability, (2) the range of single intervals, and (3) assignment of an impact to one of the intervals depend on individual judgement, making the impact materiality assessment a combination of three individual assessments. As a conclusion, the high degree of judgement in the impact materiality analysis and the not yet developed consistency in undertakings' practice will lead to divergent reporting results in the first few years of ESRS application – even in case of similar sustainability topics, the same industry sector, or similar economic activities. Implementation guidance – as currently discussed – may mitigate this up to a certain extent, but by no means completely. Therefore, a certain degree of acceptance and tolerance is required from all parties involved with regard to the differences in application; in the medium term, however, we expect a consistent practice to emerge.

Comments on chapter 3 How is the materiality assessment performed?

The DRSC has serious concerns with regard to the figures to illustrate examples of assessing the materiality of actual impacts (figure 4) and potential impacts (figure 5). Based on a scale of five intervals, ranging from "Low" to "High", figure 4 presents several combinations of the single factors' assessment (Scale, Scope, Irremediability) as well as the resulting assessment on severity, hence, materiality of actual impacts. Further, the figure suggests that any combination with just one factor being assessed "High" results in severity being classified as "High" and the impact being assessed material. In light of the wording of ESRS 1.AR11 we do not consider this conclusion to be appropriate. In contrast, we understand ESRS 1.AR 11 to state that "any of the three characteristics (scale, scope, and irremediable character) can [in the meaning of 'may'] make a negative impact severe" but that there are situations in which an impact can be categorised as not severe (i.e., not material) even though a factor has been assessed as "high". Thus, the figure does not capture the edges of the possible spectrum and may therefore be misleading. We note the disclaimer ahead of the figure, however, we do not think this alleviates these concerns, as visualisations are often more powerful than words.

A similar concern arises on figure 5: As ESRS 1.45 states that „in the case of a potential negative human rights impact, the severity of the impact takes precedence over its likelihood", likelihood clearly does matter for all topics, sub-topics, etc. other than human rights. More precisely, there are circumstances in which a very severe impact may be considered a potential impact that is not material in accordance with the ESRS because it is the least likely to occur. However, the figure 5 suggests that a potential impact shall be considered material even if its occurrence is remote. Therefore, the DRSC believes that the figure 5 is misleading as it does not consider this case.

Comments on chapter 5.4 FAQs on stakeholder engagement

The DRSC believes that the discussion of the process on stakeholder engagement in section 3 is relevant from a practical perspective and appropriate in terms of the specific level of detail. We agree that stakeholder involvement is an important element of the materiality analysis carried out by undertakings. However, due to the CSRD/ESRS requirements and other regulations, we note that dialogue with civil society organisations is becoming much more in demand. This may result in overburdening certain stakeholders in future, and initial trends (shrinking ability to cooperate) can already be observed. Therefore, we believe it is key that stakeholders must be approached and involved in a highly differentiated and targeted manner (in the interests of both companies and stakeholders): In our experience, dialogue with particularly critical stakeholders is often very helpful, but this requires both a willingness to engage in dialogue and the appropriate expertise on the part of all those involved. We understand the statement in paragraph 192 of the MAIG points to this problem, but in our opinion should be reworded to make the above clearer. In addition we note that FAQ16 focuses on affected stakeholders which clearly are an important part of the sustainability reporting audience whose interests must be reflected in the reporting. However, users (e.g., investors) form an equally relevant part of this audience. Therefore, we believe the MAIG should also discuss the relationship between the two groups and how the interests of the two groups relate to each other.

Furthermore, we welcome the guidance on silent stakeholders addressed in FAQ17. In our view, identifying the silent stakeholders likely to be impacted by the undertaking's activities (para 195, point a) is a necessary step to take before entering further analysis. However, we believe this element should be presented in the MAIG separately as a condition to be met before any meaningful analysis of silent stakeholders' interests can be performed.

Comments on chapter 5.6 FAQs on reporting

FAQ 23 (When an undertaking has actions in place to avoid, minimise, restore, or compensate environmental impacts, shall it report on the impacts before those actions?)

The DRSC strongly advocates allowing companies to decide whether to report the effects on a gross or net basis. We acknowledge that there are two levels to be considered here: First, identification of actual and potential impacts, and second, reporting on these. We agree with EFRAG that the identification of impacts should be based on a gross assessment; however, the qualitative characteristics of information as set out in Appendix B of ESRS 1 should guide the decision whether to report on a gross or a net basis. That said, we believe that a complete set of disclosures on impacts on a gross basis is neither relevant nor faithful if the probability of those impacts is very low. For example, a sustainability report that contains numerous topics that are not actually associated with any risks or impacts after considering avoidance measures might not meet the characteristic of faithful representation because it could obscure relevant information from the users of sustainability reports. Reporting would not provide any additional information for stakeholders if measures already implemented to avoid impacts were not considered when disclosing impacts or potential impacts. In such cases, we believe that the disclosures should be limited to cover brief information on the avoidance measures. However, this is not clear enough from the MAIG.

Comments on chapter 5.7 FAQs on Art. 8 EU Taxonomy

The DRSC agrees that processes established by an undertaking for the purpose of taxonomy reporting can result in findings that are also relevant for the materiality assessment in accordance with ESRS. However, we note that a number of further processes may likewise inform the materiality assessment, such as risk management, investment decision processes, etc. In other words, it remains unclear why the EU Taxonomy is explicitly (and exclusively) referenced to in this respect.

Furthermore, we note that taxonomy reporting and ESRS reporting are very different from a conceptual perspective. Therefore, the way FAQ 25 is trying to connect both pieces of regulation appears artificial and not feasible for a number of reasons: First, unlike the ESRS, taxonomy reporting is not based on a materiality principle. Second, both pieces of regulation do not share the same subject as the Taxonomy Regulation focuses on economic activities, whereas the materiality analysis according to ESRS focuses on sustainability topics (topics, sub-topics, sub-sub-topics). Finally, both regulations have a different scope. For example, the Delegated Acts to the Taxonomy Regulation only cover some (albeit the majority) of economic activities, whereas the materiality analysis in accordance with ESRS covers all activities and materiality topics. Applying the concepts relevant for taxonomy-eligible activities (such as the criteria for substantial contribution) to the materiality assessment under ESRS as detailed in FAQ 25 will create an expectation gap as to whether the content of FAQ 25 also applies to non-eligible activities, even if FAQ 25 explicitly refers to eligible activities. Furthermore, listing the details such as points (a) and (b) of para 224 might force preparers either to take these steps or otherwise explain why these have not been taken. This should clearly be avoided.

Although we welcome the attempt to highlight some commonalities between these two pieces of legislation in general, we do not think that the place and the manner to do this exercise seems appropriate. Instead, we believe that this can only be achieved by adapting the respective legal texts.

Concluding, we propose to restate this FAQ so that it, firstly, asks which internal processes of an undertaking can inform the materiality analysis in accordance with ESRS, and, secondly, refers to an undertaking's risk management, due diligence processes, the processes to support investment decisions and the processes established for taxonomy reporting in the answer. No further detail should be provided.

Comments on Draft IG 2: Value Chain (VCIG)

Comments on chapter 2 Navigating value chain under CSRD and ESRS (topic: operational control)

According to ESRS 1.62 the sustainability statement shall be for the same reporting undertaking as the financial statements. Article 22 of the Accounting Directive clearly defines what constitutes a group of undertakings consolidated by a parent undertaking. The characteristics outlined there are also understood as the financial control concept. I.a.w., financial control is the guiding principle for the definition of the reporting undertaking. We acknowledge that, based on the guidance stemming from the Greenhouse Gas Protocol, there are some exceptions from this principle in relation to some E-Standards as set out in ESRS, in particular E1, E2, E4; however, ESRS do not provide for such exemptions in relation to other ESRS, including the S-Standards. In summary, we have strong concerns as to whether the content of the paragraphs 45 and 47 is consistent with the ESRS. We therefore urge to clarify in the VCIG that operational control is relevant for the aforementioned ESRS only. An expansion of this concept to other ESRS can only be achieved by amending the standards themselves.

Comments on chapter 3 FAQ6 Should VC information be included for Metrics Disclosure Requirements?

The FAQ also states that an undertaking is required to provide entity specific Value chain (VC) metrics or to integrate VC data into their metrics when, according to the outcome of its materiality assessment, this is necessary from an entity-specific perspective. To support this statement, reference is made to ESRS 1.11, ESRS 1.AR 1 to 5 and to ESRS 1.65. The DRSC does, however, not believe this link is convincing. We acknowledge that ESRS contain requirements on (1) entity-specific disclosures including metrics and (2) value chain related disclosures in the aforementioned paragraphs. However, ESRS 1 does not draw an explicit connection to both pieces of the standard. Therefore, the DRSC is of the opinion that the conclusion drawn in the VCIG could be plausible, but that the requirements leave the same room for a contrary interpretation. We have observed that the trickle-down effect to SMEs that are part of an undertakings VC was repeatedly discussed throughout the whole period of ESRS development from the outset. In this context, it was clearly stated that this effect should be minimised as far as possible, but an interpretation of the ESRS requirements on VC related metrics as done in the VCIG would run counter to this intention. Against this background, we think that the ESRS requirements are not clear on this question. We agree that a clarification is needed but it should be addressed by an amendment to ESRS rather than non-authoritative implementation guidance.

Comments on chapter 3 FAQ7 How to assess and quantify the impacts of the VC resulting from business relationships?

We agree with the statement right at the beginning of this FAQ that direct information should be favoured, and we welcome the explanations on how to obtain VC related information. However, the DRSC believes that this section lacks clear reference to risk analysis with regard to impacts, as this forms the core of the identification and assessment/quantification of impacts in the value chain. In order to analyse the risk of significant impacts, it is necessary (or at least helpful) to categorise the risks before. Such categories include country risks, industry risks, and product risks, among other things. Although the VCIG refers to certain risk categories in some places (e.g., industry and country risk category in section 2.2, product risk category in FAQ1), it does not go into the necessary detail with regard to risk categorisation, particularly in FAQ7. The VCIG suggests that for an impact to be assessed material the significance of products obtained from a certain supplier is of relevance; however, we believe it does not play the leading role because even insignificant products may be associated with material impacts. Therefore, we think that EFRAG should restate the statement in para 130 of the VCIG (e.g., "the undertaking does not need to query all direct suppliers and could exclude those that deliver insignificant products or services to the undertaking").

Comments on chapter 3 FAQ9 How can estimates be developed when primary data cannot be collected from VC counterparties?

The DRSC believes that the guidance provided is helpful, in particular the examples of external sources mentioned in the green box on page 28. We observe that the process of identifying and selecting such sources currently has to be carried out by each undertaking itself, which results in very high efforts for the economy as a whole. A comprehensive list at a central point might significantly reduce the search costs for undertakings and would certainly contribute to an improvement in reporting. In our view, the VCIG would be a suitable place for this.