Stellungnahme zu den Entwürfen der European Sustainability Reporting Standards

Die WPK hat mit Schreiben vom 27. Juli 2022 gegenüber der European Financial Reporting Advisory Group (EFRAG) zu deren Entwürfen der European Sustainability Reporting Standards wie nachfolgend wiedergegeben Stellung genommen:

The German Chamber of Public Accountants (Wirtschaftsprüferkammer WPK) is pleased to take this opportunity to comment on the Exposure Drafts on European Sustainability Reporting Standards (ED ESRS).

We support the European Union's legislative initiative on sustainability reporting under the Corporate Sustainability Reporting Directive (CSRD). We consider the CSRD, alongside with the EU Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR), as the important pillars of the EU sustainable finance strategy to channel capital flows into sustainable green investments.

Mandatory standards for sustainability reporting increase the comparability and the informational value of sustainability reporting for stakeholders. In this context, we welcome the intended assurance obligation for sustainability reports. The assurance requirement contributes to increasing the credibility and reliability of reporting and is thus an important instrument for bringing sustainability reporting and financial reporting on an equal footing. The sustainability reporting standards represent the target object on which the assurance of sustainability reports is based.

In order for sustainability reporting standards to fulfil these tasks, they must be comprehensible, clear and unambiguous, enable practicable and proportionate application and ensure consistent reporting on the material ESG issues of the reporting company ("common thread"). In doing so, it is important to avoid an overflow of information.

From our point of view, a good basis has been created with the present ESRS drafts within an ambitious time frame. Nevertheless, we see the need for a further revision. We therefore take the liberty of addressing some essential points of criticism below and hope that these will be considered in the further standard-setting process.

Insufficient timeframe for standard-setting and for commenting these standards

With the planned adoption of the ESRS by the European Commission by October 2022 and a first application of the CSRD plus the EFRAG reporting standards from 2023, the CSRD draft sets an extremely ambitious timeframe. The development of the present ESRS drafts is therefore understandably taking place under high time pressure.

However, we consider a comment period of only 100 days for the approximately 400-page draft of the EFRAG reporting standards and the consultation documents, which are at least as extensive, to be **insufficient**. The draft EFRAG reporting standards build the foundations for the sustainability reporting of about 50,000 directly affected companies in Europe.

Sustainability reporting is not just about compiling information on sustainable indicators or impacts, risks and opportunities. Rather, the companies concerned are required to set up or establish processes (e.g. materiality assessment, internal controls, due diligence), structures (reporting channels, systems, responsibilities) and strategies (alignment of corporate activities with the 1.5-degree global warming target) in order to ultimately achieve a transformation of their activities towards sustainable business. **An intensive discussion and evaluation of the draft EFRAG reporting standards, which is appropriate to the importance of sustainability reporting, is not possible within the given comment period.**

The time frame, but also the limited staff capacities at EFRAG, also cause us **considerable concern with regard to the evaluation and the consideration of the comments in the further standard-setting process.**

Lack of SME perspective in the draft EFRAG reporting standards

Compared to the NFRD, the CSRD-draft provides a massive expansion of the scope of reporting. While up to now only large listed companies, banks and insurance companies with more than 500 employees are obliged to report non-financial information (Germany: approx. 500 companies, Europe: approx. 11,000 companies), in the future all large corporations, banks and insurance companies, regardless of listing and number of employees, as well as listed small and medium-sized companies are to be obliged to report (Germany: approx. 15,000, Europe: approx. 50,000). This figure does not include a supposed large number of indirectly affected companies - mainly small and medium-sized - that have to collect sustainability information due to their affiliation to a group or their integration in the value / supply chain of another company.

Against the background of the large number of affected medium-sized non-listed companies, the EFRAG reporting standards must enable **a practicable and proportionate application**. Unfortunately, **we don't see these two essential requirements in the draft EFRAG reporting standards**. The opposite seems to be the case: For example, the draft governance standards ED ESRS G1 and G2 require all companies subject to reporting requirements to disclose, among other things, information on the functioning of the boards, the remuneration system and the diversity concept, which in Germany is currently only required of listed companies. The target group of EFRAG's draft reporting standards thus seems to be the **large multinational listed company**.

It is worth mentioning that the International Financial Reporting Standards (IFRS), which also target large listed companies, contain a separate accounting standard for small and medium-sized enterprises (IFRS for SME), as the full IFRS are not practicable for this business segment.

The total of around 140 overarching disclosure requirements (DR), which are again significantly expanded by further detailed requirements in the standards and additional explanations in the application guidelines, are hardly manageable for medium-sized, non-listed companies. In addition, the companies have to define, implement and document processes and structures for the fulfilment of the reporting obligations - partly required by the draft standards, partly due to the subject matter. This may be feasible for large, capital market-oriented companies that already prepare non-financial reports according to the NFRD and have the corresponding capacities and structures.

However, the majority of the (medium-sized) companies concerned are being confronted with sustainability reporting for the first time. It can therefore be assumed that **the necessary competences, processes and structures as well as the corresponding personnel capacities are not or not sufficiently available** at these companies.

The problem of lack of proportionality and practicability is exacerbated, especially for medium-sized companies, by the fact that the EFRAG reporting requirements must be determined as part of a comprehensive and complex materiality assessment process while taking the company's value chain into account (see below).

Therefore, we favour a proportionate applicability of standards that consider the size, complexity and risk of the reporting entity. The intended development of EFRAG reporting standards for small and medium-sized entities (Set 2) partly takes this idea into account. However, the standards in Set 1 must also meet this requirement, as they are intended to be applied by both large listed companies and medium-sized, non-capital-market-oriented companies.

Medium-sized companies which are strongly affected by the draft CSR Directive and the draft EFRAG reporting standards, are additionally burdened by the further reporting obligations from the **EU Taxonomy Regulation** and the related delegated regulations on the classification of economic activities, the determination of the green key performance indicators (turnover, OpEx, CapEx) and corresponding disclosures. In addition, there are contemplations about an **EU social taxonomy**. In this context, it is also worth mentioning the further regulatory requirements of the draft directive on Corporate Sustainability Due Diligence (CSDD), the ESEF regulation (European Single Electronic Format) and the draft ESAP regulation (European Single Access Point).

In addition to **overburdening** medium-sized companies with reporting obligations, we fear a flood of sustainability-related detailed information at this point, which is not comparable and does not help to encourage companies to operate sustainably.

The results of the cost-benefit analysis announced by EFRAG (cf. EFRAG publication of 6.5.2022: "EFRAG extends deadline to respond to its call for tender for the cost-benefit analysis of the first set of draft European sustainability standards") should in any case be considered in the further standard-setting process.

Disclosure of internal company information and trade secrets

In addition to the sheer volume of information required, we also consider certain disclosure requirements to be questionable against the background of the **disclosure of internal company information and company secrets**. For example, we consider the key drivers of value creation to be explained according to ED ESRS 2 (DR2-GR 4) to be problematic. In this respect, a revision of the draft standards seems necessary.

At this point, we suggest the inclusion of an exemption rule according to which the company can or must omit information if the disclosure of the information is likely to cause a disadvantage to the member state (cf. § 268 para. 1 HGB) or the company (cf. § 268 para. 2 HGB).

Lack of a common thread and insufficient manageability

The structure of the thirteen draft EFRAG reporting standards with two overarching standards and the remaining thematic standards in categories E, S and G is comprehensible. The basic structure of the individual thematic standards (Objectives; Disclosure Requirements with I. General, Strategy, Governance, Materiality Analysis, II. Policies, Goals, Action Plans, Resources, III. Performance Measure; Appendix) also facilitate understanding and navigation through the standards. However, the "**common thread**" of the reporting requirements is lost in the various building blocks and individual requirements.

For example, ED ESRS 1 - *General principles* in section 2.5 *Due diligence under the CSRD* in Appendix C - *Explanations on sustainability due diligence* contains comprehensive information on the company's sustainability due diligence process. This is further specified in part in the rest of ED ESRS 1, but also in part in ED ESRS 2 - *General, strategy, governance and materiality assessment*. Additional requirements are included in the thematic standards and/or their application guidance. ED ESRS 2 (DR 2-Gov 5 i.e. AG 55) requires the reporting company to link the relevant individual disclosures in the sustainability report with the material aspects of the sustainability-related due diligence in the form of a table. This table should then be used to show the report addressee which statements on the due diligence process can be found at which point in the sustainability report.

Furthermore, the role of the **application guidelines** is not clear in the draft EFRAG reporting standards. For example, the introductory part of all draft standards more or less literally describes the mandatory character of the application guidelines (e.g. ED ESRS S1 - *Own Work-force*: "This appendix is an integral part of the [draft] ESRS S1 Own workforce. It describes the application of the requirements set for in paragraphs 12-118 and has the same authority as the other parts of this [draft] Standard"). However, the individual application guidance documents contain **explanations** on the interpretation and understanding of a disclosure requirement, as well as **requirements** that **go beyond the disclosure requirements of the standard itself** (see ES ESRS S1, para 14-22 on DR S1-1, and the related AG11 - AG31). In addition, the application guidelines of various thematic standards contain notes and explanations that **elaborate** on certain reporting requirements of the **cross-cutting standard** ED ESRS 2 on *General, strategy, governance and materiality assessment*. We advocate a clear separation between the mandatory requirements in the standard text and only supplementary and explanatory notes in the application guidelines. This would be in line with standard-setting practices, e.g. in the area of auditing standards, and would increase the manageability and clarity of the draft reports.

Overall, the nesting of the individual draft standards in conjunction with the additional modules in the application guidelines leads to a fragmentation and distribution of requirements that are related in content, which significantly limits the manageability of the draft standards and increases the risk of overlooking individual reporting obligations. Here we see the need for a clearer and more comprehensible structuring of the draft standards.

Broadly defined stakeholder group

The group of stakeholders to be considered by the companies concerned in the context of sustainability reporting includes *all persons who are or may be affected by the decisions and activities of the company* (ED ESRS 1, para. 44). *There are two main stakeholder groups:*

a) Affected stakeholders (individuals or groups that have interests that are affected or could be affected - positively or negatively - by the undertaking's activities and its value chain) and

b) users of sustainability reporting: stakeholders with an interest in the undertaking:
i. existing and potential investors, lenders and other creditors (including asset managers, credit institutions, insurance undertakings); and
ii. business partners of the undertakings, trade unions and social partners, civil society organisations and non-governmental organisations.

We consider this definition of stakeholder to be very broad and difficult to apply. With regard to a), the question arises as to how a company should continuously identify potential individual interests of persons along its value chain. Users of sustainability information in the sense of b) and thus stakeholders to be considered would in principle be all organisations and institutions that have a person capable of reading sustainability reports.

According to ED ESRS 2 (para. 19), the reporting company must, for example, present the *key drivers of its value creation* considering the interests of all stakeholders (...*in taking account of the respective interests of <u>all</u> stakeholders.*). This consideration of all potentially conceivable information interests is difficult to manage and leads to an information overload that calls into question the information value of sustainability reporting.

In any case, the interests of **individuals** should **not be considered** and stakeholders should always be understood as **groups** of individuals or organisations with comparable information interests.

It would also be conceivable to focus on selected material **stakeholder groups**. As we understand it, the ISSB's draft standards also place the information interests of investors at the forefront of their reporting requirements.

Difficult concept of double materiality

ED ESRS 1 contains the concept of double materiality with the characteristics of impact materiality and financial materiality. A sustainability matter is considered material for the purposes of double materiality if it is material according to impact materiality or financial materiality.

The explanations in ED ESRS 1 and the supplementary definitions in Appendix A on impact materiality and financial materiality are **broad and not very specific**.

Regarding the *impact materiality*, an impact may be actual or potential, negative or positive. *Actual* impacts should then be assessed according to their severity, subdivided into scale, scope and remendability. For *potential* impacts, the likelihood of their occurrence should also be determined. In addition, impacts may be short-, medium- or long-term. Consideration should also be given to whether they are directly-linked to the company's activities, products or services, and to its value chain.

Financial materiality, on the other hand, is explicitly not congruent with financial materiality in accounting (cf. ED ESRS 1, para. 52). The definition is also deliberately broad and includes all material risks and opportunities arising from past or future events that may affect the net assets, financial position and results of operations and thus the enterprise value in the short, medium or long term, but are not or not fully reflected in the financial reporting at the reporting date. The valuation is a combination of the probability of occurrence and the magnitude of the financial impact.

ED ESRS 1.43 requires the entity to establish thresholds and/or criteria for reporting. However, the draft standard does not provide guidance on the quantitative determination of materiality.

Based on this, ED ESRS 2 provides for the obligation to define and report on the materiality assessment process for identifying and determining the materiality of the sustainability-related impacts, risks and opportunities of the entity itself and its value chain.

In summary, it is not clear where the boundary between material and immaterial information lies. A quantitative concretisation fails due to the high degree of subjectivity in the individual interpretation of what is relevant and thus material information. The overly broad definition of the group of stakeholders whose interests are to be considered in determining materiality makes this even more difficult. **In this context, we recommend a more precise definition of materiality and guidance in the definition of threshold values**.

Insufficient convergence with ISSB reporting standards.

A coexistence of different, less compatible frameworks of EFRAG and ISSB should be avoided. This would impose an unnecessary double burden on sustainability reporting for internationally active or listed companies based in Europe.

However, the 73-page reconciliation table attached as Appendix V to the Cover Note for Public Consultation for only three ESRS to two IFRS Sustainability Standards (SS) gives an idea of the effort a reporting company would currently have to go to in order to ensure compliance with the requirements from both frameworks.

This does not consider the more extensive disclosure requirements under ED ESRS, which result from the double materiality in connection with a broader stakeholder group in comparison. The IFRS SS of the ISSB focus here on financial materiality and financial investors.

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We hope that you find our comments helpful and will be pleased if they are considered in the ongoing standard setting process. In case of any questions, we should be pleased to discuss matters further with you.

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