Get ready for European Sustainability Reporting Standards

Understanding the first set of draft ESRSs

November 2022

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What's the issue?

Under the proposed CSRD[1], many more companies in the EU will need to prepare extensive sustainability reports as part of their management reports.

EFRAG was mandated to develop draft ESRSs setting out the detailed disclosure requirements under the CSRD by the European Commission. After public consultation, EFRAG has now proposed a first set of draft ESRSs to the European Commission for adoption.

The draft ESRSs cover environmental, social and governance topics. Additional sector-specific standards are planned for release in due course.

The draft ESRSs introduce the concept of double materiality (multi-stakeholder approach) and expand a company's reporting boundary to its entire value chain.

What's the impact?

The draft ESRSs are ambitious and would have a significant impact on the scope, volume and granularity of sustainability-related information to be collected and disclosed by companies.

ESRSs would be applied by:

- all large and most listed EU companies;
- large subsidiaries of non-EU parents (group exemptions apply); and
- non-EU companies with a turnover in the EU of more than EUR 150 million.

A company would need to report on how its activities and value chain affect the environment and people, as well as how sustainability matters affect its cash flows, financial position and financial performance.

What's next?

1. Make yourself familiar with the proposed reporting requirements under the draft ESRSs.
2. Identify what you would be required to report.
3. Prepare: based upon a phased timeline, adoption would start for certain companies for years beginning on or after 1 January 2024.

1 Based on CSRD as adopted by the European Parliament and the European Council in November 2022. In order to become effective, the CSRD still needs to be published in the EU Official Journal and transposed into national law.

Abbreviations and key terms

10 questions to start getting ready

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01 What has been released?

Ten topic-specific draft standards

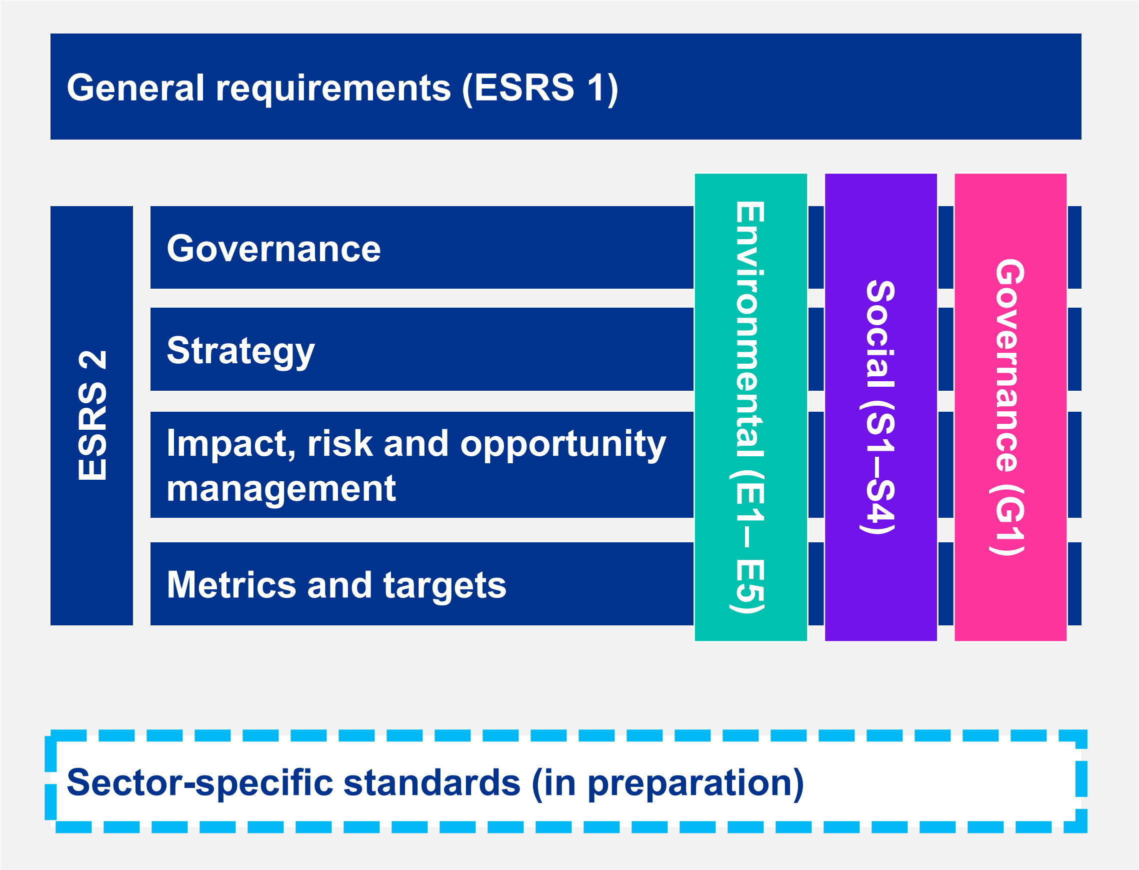
- Provide topic-specific application guidance on:
  - Governance;
  - Strategy; and
  - Impact, risk and opportunity management.
- Establish metrics and explain how to disclose related targets for each topic.

Two cross-cutting draft standards

- Explain fundamental concepts from the CSRD.
- Set cross-cutting disclosure requirements applicable to all topics for:
  - Governance;
  - Strategy;
  - Impact, risk and opportunity management; and
  - Metrics and targets.
- Provide principles of disclosure and presentation structure.
- Establish transitional provisions.

For future release: Sector-specific standards

- 41 additional standards to address additional sector-specific requirements are being developed for later adoption.

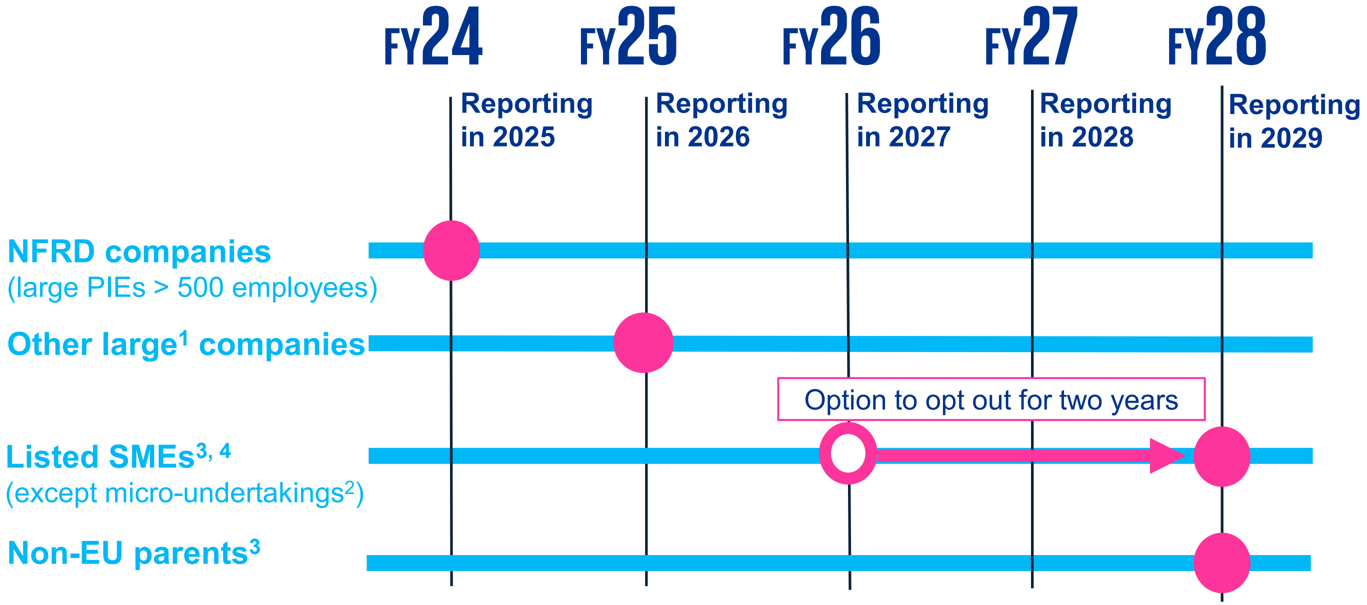


02 When and to whom would ESRSs apply?

When: ESRSs would apply for years beginning on/after 1 January 2024 (reporting in 2025). Phased introduction would start with companies already subject to reporting requirements under the NFRD (i.e. large PIEs with more than 500 employees).

Who: Ultimately, ESRSs would be applied by (group exemptions may apply):

- large EU companies[1];
- listed EU companies (except micro-undertakings[2]); and
- ultimate non-EU parent companies[3] with a combined group turnover in the EU of more than EUR 150 million.



1 Large companies are those that exceed on the balance sheet date two of the following three criteria (including EU and non-EU subsidiaries): 250 employees, net revenue of EUR 40m or total assets of EUR 20m.

2 Micro-undertakings are companies that do not exceed two of the following three criteria (including EU and non-EU subsidiaries): 10 employees, net revenue of EUR 700,000 or total assets of EUR 350,000.

3 Separate standards will be developed for SMEs and non-EU parent companies (to be adopted by the European Commission by 30 June 2024).

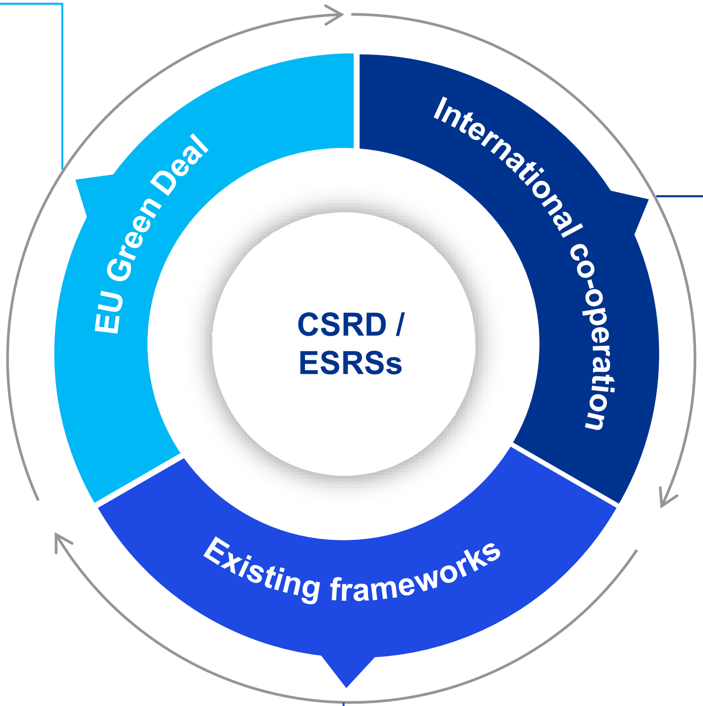
4 Small and non-complex institutions and captive insurers are treated like listed SMEs (opt-out option until 2028 does not apply unless they also meet the definition of SME).

The first set of ESRSs is due for finalisation by June 2023. The second set of standards – to include sector-specific standards, standards for SMEs and a standard on non-EU parent companies – is due for finalisation by June 2024.

03 What are ESRSs based on?

EU Green Deal

Designed to support the European Green Deal and to be aligned with existing sustainability frameworks in the EU (e.g. SFDR and EU Taxonomy).



International co-operation

EFRAG has and will continue to co-operate with the ISSB to achieve interoperability and to maximise convergence between ESRSs and IFRS® Sustainability Disclosure Standards.

Existing frameworks

EFRAG has aligned reporting areas with those used in the TCFD's recommendations. Many disclosure requirements are similar to or based on these recommendations and the standards developed by the GRI.

The CSRD requires ESRSs to take account of global standard-setting initiatives for sustainability reporting to the greatest extent possible. However, ESRSs will go further where necessary to meet the EU's own ambitions and to be consistent with the EU's legal framework.

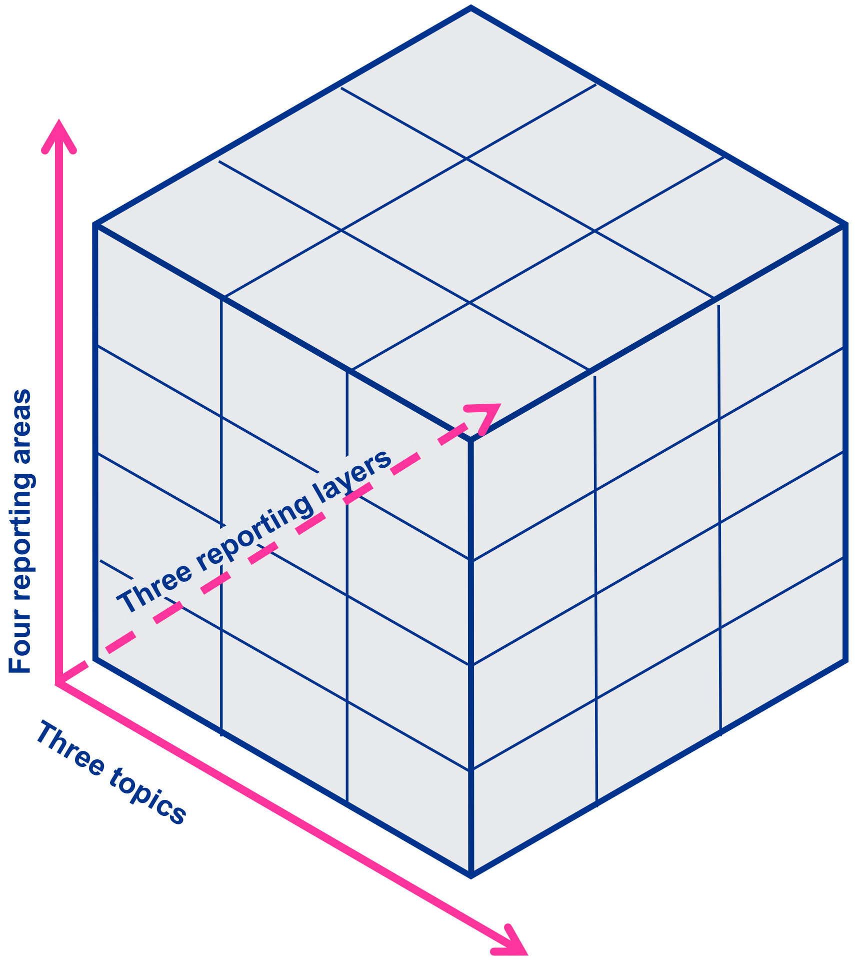
04 What would companies need to disclose?

Four reporting areas

- **Governance** – disclosures relating to the governance of sustainability topics; would apply to all companies.
- **Strategy** – disclosure requirements in this area would apply to all companies and all topics.
- **Impact, risk and opportunity management** – disclosures on impacts, risks and opportunities would need to be provided for topics that are assessed to be material.
- **Metrics and targets** – specific sets of sector-agnostic metrics and targets that would need to be disclosed for material topics by a company regardless of its industry.

Three reporting layers

- **Sector-agnostic disclosures** – disclosure requirements applying to all companies (for maximum comparability).
- **Sector-specific disclosures** (41 standards under development) – disclosure requirements applying to companies of a specific sector (for maximum relevance).
- **Company-specific disclosures** – additional disclosure requirements on material impacts, risks and opportunities not covered by topical standards.



Three topics

- **Environmental**:
  - Climate change
  - Pollution
  - Water and marine resources
  - Biodiversity
  - Resource use and circular economy
- **Social**:
  - Own workforce
  - Workers in the value chain
  - Affected communities
  - Consumers/end-users
- **Governance**:
  - Business conduct

05 What phase-in measures would apply?

The draft ESRSs include specific reliefs that companies could apply in the early years of adoption to support them in transitioning from existing methodologies or reporting frameworks.

Year 1 relief

Comparative information would not be required.

Year 1-3 reliefs

Other available frameworks could be used to develop relevant disclosures on material sustainability matters in advance of sector-specific ESRSs.

Information on the value chain would not need to be estimated and could be omitted if information is not available[1].

Company-specific disclosures developed prior to initial application may continue to be used.

Longer period

EU subsidiaries of non-EU parents could choose to prepare only one combined report including all those subsidiaries that would be obliged to report independently of the remaining group due to size or listing status.

Additional phase-in measures are proposed to apply to various areas, aspects and specific disclosure requirements with time periods ranging from one to three years.

1 This phase-in is not applicable to datapoints relevant for other EU laws or based on internal information. It includes both upstream and downstream information.

06 What is double materiality?

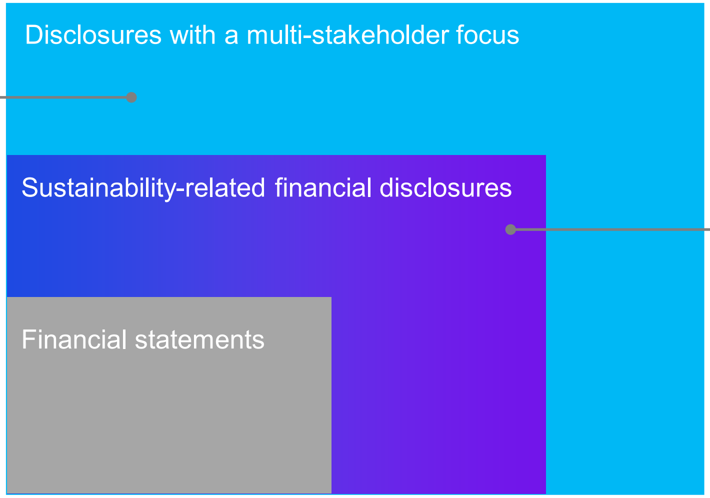
Company-specific materiality assessments

Double materiality refers to two dimensions of materiality – 'financial' and 'impact'.

Companies would need to perform materiality assessments for both dimensions and report matters that are material in either dimension.

Companies would be able to conclude that information is immaterial either on the level of a topical standard, on the level of an individual disclosure requirement or even a single datapoint.

Certain disclosure requirements would be mandatory and independent from the company-specific materiality assessment. This would apply, for example, to all cross-cutting disclosures (ESRS 2) and disclosures in ESRS E1 (on climate) as well as certain disclosures in ESRS S1 (on the company's own workforce).



Impact materiality

Based on draft ESRSs, impact materiality would require disclosure of sustainability matters that relate to a company's material actual or potential, positive or negative, impacts on people or the environment over the short-, medium- or long-term.

Application requirements in ESRS 1 specify the steps that would have to be considered to assess impact materiality.

This assessment includes impacts in a company's upstream and downstream value chain.

Materiality would be assessed based on severity and likelihood of the impact.

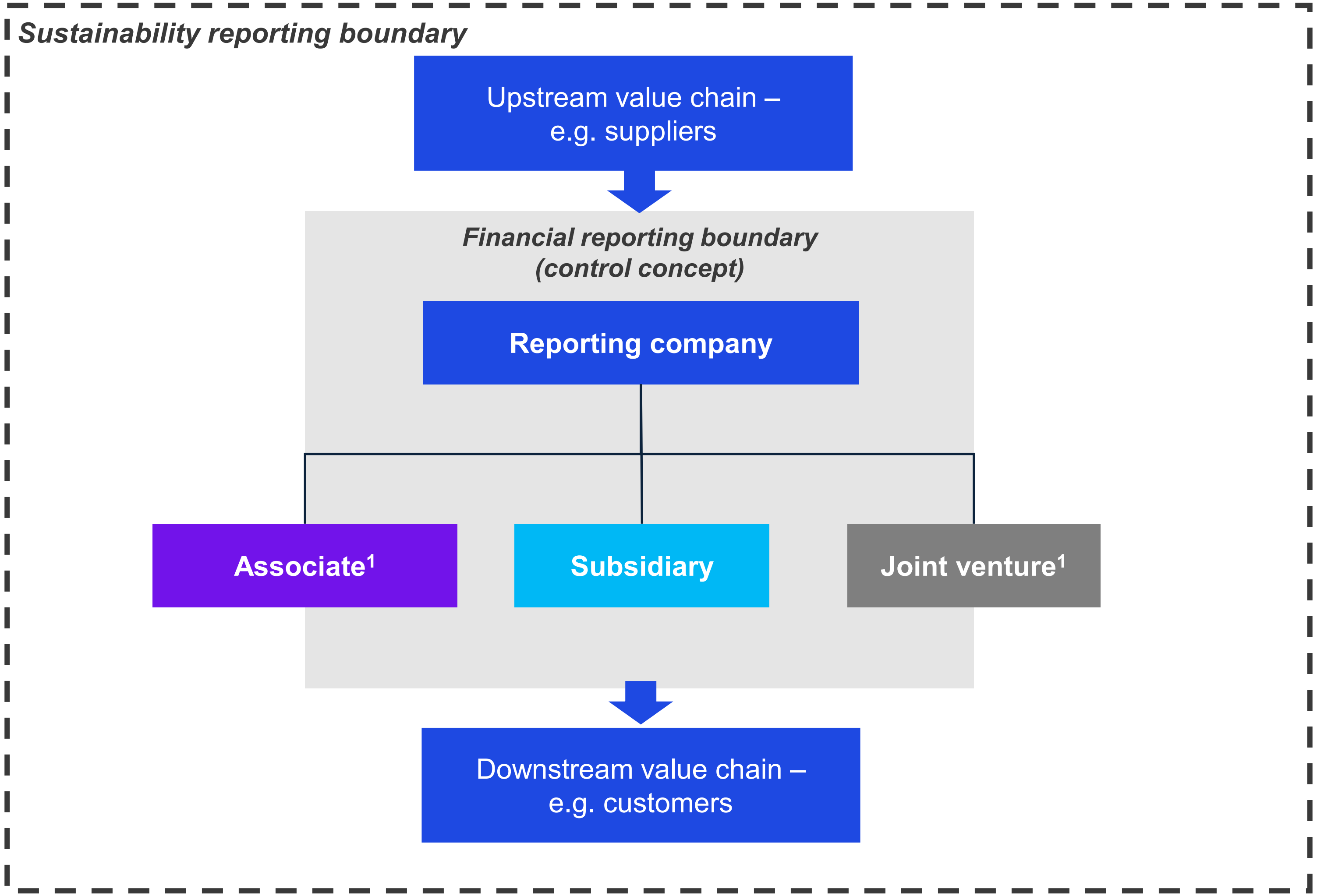
Financial materiality

Based on draft ESRSs, financial materiality would require disclosure of sustainability matters that (may) trigger material financial effects on a company's development, e.g. cash flows, financial position or financial performance, in the short-, medium- or long-term.

This assessment would not be limited to matters within the company's control.

Materiality would be assessed based on likelihood and (potential) size of the financial effect.

07 What reporting boundary would you consider?



Reporting boundary for sustainability reporting

The reporting boundary would be based on the financial statements - but expanded to cover material impacts, risks and opportunities related to the upstream and downstream value chain.

If information from the value chain is not available, a company would use estimated data using all reasonable and supportable information. In the first three years of application, draft ESRSs would allow transitional measures if information cannot be obtained.

The ability to obtain necessary data depends on various factors, for example the contractual arrangements in place and the level of control over the value chain.

1 Equity investments and joint ventures may form part of the upstream or downstream value chain.

08 What if you have already adopted other frameworks?

Build and adapt

- Identify conceptual differences from existing frameworks by comparing definitions, guiding principles and the basis of preparation as well as the principles of cross-cutting requirements.
- Assess the scope of the draft ESRSs. Because they may be significantly broader than any existing sustainability reporting framework, companies that adopt other frameworks would need to identify any gaps and assess what action is needed to fill the gaps.
- Map how specific disclosure requirements in the draft ESRSs differ from those in the existing frameworks.
- Identify where additional data would be needed and whether frameworks would allow collaborative reporting or require the company to issue two separate reports.

Existing sustainability information set

↓

Refocus and supplement as necessary

Align definitions and methodologies	Reassess materiality
Identify and assess gaps	Expand the reporting boundary

Items to consider if previously adopted TCFD

- The scope of ESRSs is broader than TCFD because they apply the double materiality concept; TCFD applies a materiality concept focused on investors. TCFD focuses on climate only, so companies would need to significantly expand their disclosures on other environmental topics as well as social- and governance-related disclosures.
- EFRAG published a reconciliation of the requirements in the draft ESRSs and the recommendations by TCFD.

Items to consider if previously adopted GRI standards

- Disclosure requirements are partly based on GRI standards and closer alignment has been achieved as a result of the public consultation.
- Under the draft ESRSs, companies could include disclosures based on GRI standards when developing their company-specific disclosures.

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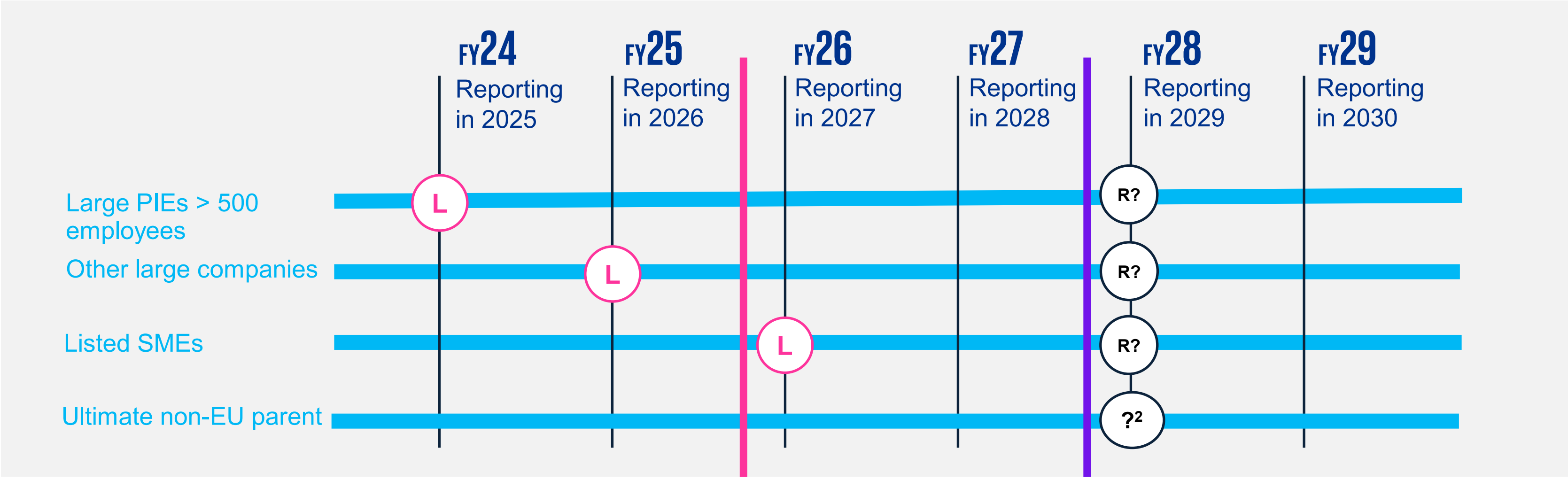
09 What about assurance?

- CSRD proposals would require assurance across all topics:
  - Limited assurance from the date of initial reporting.
  - Ambition to move to reasonable assurance at a future date.
- Member states may choose to allow assurance over sustainability reporting to be separate from the financial statement audit (i.e. by a separate auditor or independent assurance provider).



European Commission to adopt limited assurance standards

European Commission to adopt reasonable assurance standards following feasibility assessment

L Limited assurance[1] required

R? Reasonable assurance[1] subject to feasibility assessment

Limited assurance is a level of assurance at an acceptable level that, based on professional judgement, is meaningful for the intended users. It results in a negative conclusion (i.e. 'nothing has come to our attention to indicate that the information is materially misstated').

Expressing reasonable assurance requires the assurance provider to obtain sufficient appropriate evidence to conclude that the sustainability information is prepared, in all material respects, in accordance with the applicable reporting criteria (positive conclusion).

1 Read more about ESG Assurance in Audit. The assurance requirements would have no bearing on a company's responsibility to report accurate information from the first reporting year – e.g. limited assurance does not mean limited reporting.

2 Assurance would be based on jurisdictional requirements of the third country parent or that of a member state. In the absence of an assurance opinion, the company would need to issue a statement indicating this.

10 What do you need to do now?

01

Educate your organisation

on the significant volume of new disclosure requirements in the draft ESRSs and what it would mean for the company and its operational processes throughout its value chain.

02

Establish a board-led governance structure

to identify impacts, risks and opportunities and perform a materiality assessment that covers not only the reporting company but also its upstream and downstream value chain.

03

Engage with current process owners

and understand how information is being defined, captured and reported, and where there are data and control gaps. This is particularly important for information that is outside the company's direct control.

04

Expand your systems, processes and controls

to identify relevant sources of content and capture the significant amount of data required to meet the disclosure requirements. This might include contractual arrangements to obtain data from third parties.

Abbreviations and key terms

CSRD

The EU's proposed Corporate Sustainability Reporting Directive, amending and significantly expanding the existing requirements for sustainability reporting in the EU under the NFRD

EFRAG

European Financial Reporting Advisory Group, which is mandated by the European Commission responsible for developing ESRSs

ESRS

European Sustainability Reporting Standards as drafted by EFRAG and submitted to the European Commission as of November 2022

EU Taxonomy

The EU's framework to facilitate sustainable investment (Regulation (EU) 2020/852)

GRI

Global Reporting Initiative

ISSB

International Sustainability Standards Board

NFRD

The EU's Non-Financial Reporting Directive (Directive 2014/95/EU)

SFDR

The EU's Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088)

TCFD

Task Force on Climate-related Financial Disclosures

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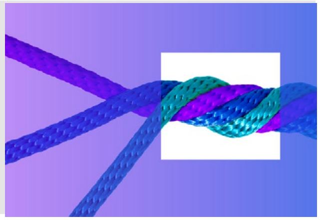
Whether you are new to sustainability reporting or a current user, you can find digestible summaries of recent developments and more detailed guidance on the current proposals.

Tracking the development of IFRS Sustainability Disclosure Standards

Comparing sustainability reporting proposals

ISSB, EFRAG and SEC



New on the Horizon – Sustainability Reporting

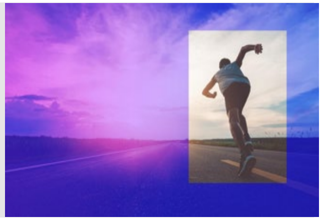
Detailed analysis of ISSB general and climate-related proposals

Digesting the SEC's climate proposal

What you should know now

Get ready for IFRS Sustainability Disclosure Standards

A high-level summary



Sustainability reporting

Read the global KPMG Impact Plan

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