INSTITUT DER WIRTSCHAFTSPRÜFER

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Mr Hans Buysse
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Advisory Group (EFRAG)
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submitted as an attachment to the IDW response to the
EFRAG Consultation Survey

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Re.: IDW's response to EFRAG's consultation on the draft European Sustainability Reporting Standards

Dear Mr Buysse

The Institut der Wirtschaftsprüfer in Deutschland e.V. [Institute of Public Auditors in Germany, Incorporated Association] (IDW) is pleased to provide its views concerning the package of draft European Sustainability Reporting Standards.

The IDW represents over 11,500 Wirtschaftsprüfer [German Public Auditors], which is approximately 80 % of all Wirtschaftsprüfer in Germany. Our members are from the only profession in Germany to have been entrusted with the performance of statutory audits of the financial statements of all entities that are legally required to have their financial statements subject to audit in Germany, including the larger publicly listed companies that are presently required to publish non-financial information (NFI). Since the enactment of the NFRD in German, there has been an increase in companies asking for voluntary assurance of NFI reporting; often from their auditor, who under German law is also required to obtain reasonable assurance on specified parts of the management report. Thus, experience with assurance in this field has also grown amongst our membership.

The IDW has previously responded to the EU Commission's Consultation concerning the EU Commission's Proposal for a Directive on Corporate Sustainability Reporting (CSRD) in July 2021 and the Document "Review of the Non-Financial Reporting Directive 2020" in June 2020.

The 2021 Proposal for a CSRD originally estimated a 30-fold increase in reporting entities in Germany. We note that the agreement reached in July relating to the finalization of the CSRD will likely increase the number of German entities and German branches of non-EU parent entities who will ultimately be required to disclose or collate, respectively, sustainability-related information under the EFRAG's standards (including those yet to be developed). This means that EFRAG's standards will have a more significant impact on sustainability reporting in Germany than in other EU Member States, including the impact of related costs on its economy.

As we discuss below in the section of this letter headed "Implementation challenges pertaining to the European Sustainability Reporting Standards", it is highly likely that many entities – and first-time reporting entities in particular – will struggle with the ambitious timeframe for implementation of the requirements established in EFRAG's Standards, notwithstanding the various extended time periods agreed in finalizing the CSRD and the later implementation envisaged for smaller entities. Because of the significance of the role a reporting entity's systems for data collation and internal control over reporting mechanisms play in meeting the EU Commission's goals for high quality corporate sustainability reporting and its assurance, entities will need adequate time to establish robust systems, including ensuring that they function effectively. Obtaining information of sufficiently quality from others within the reporting entity's value chain is a further challenge we discuss in that section.

In consequence, the IDW strongly recommends EFRAG consider how best to ease the potential burden on reporting entities. Whilst EFRAG could consider exploring whether phasing-in specific standards (e.g., cross cutting and only climate-related standards first with further environmental (ESRS E2- E5), social (ESRS S1- S4) and governance (ESRS G1-G2) standards introduced later) might be an option, in our opinion it would be preferable for EFRAG to adopt a phasing-in approach, whereby the final topical standards would require the key KPIs pertaining to a specific topic to be reported initially with more detailed granular disclosures introduced subsequently. We also suggest EFRAG consider a deferral for reporting on information to be obtained from others within the value chain. A phasing-in approach that initially focuses on key KPIs pertaining to the reporting entity will also allow more time for the key global standard-setters (EFRAG, ISSB, GRI, etc.) to work together to achieve the maximum interoperability of their respective reporting frameworks.

In this letter, we set forth the areas our members support as well as the key areas of concern we have identified in consulting with our members on the draft European Sustainability Reporting Standards as follows:

Support for the initiative and progress to date

The IDW supports the CSRD's initiative in full and agrees with many aspects of EFRAG's proposals. We would like to reiterate our general support for the EU taking the initiative forward as a significant part of the package of measures in the context of the European Commission's Green Deal objectives.

We also commend EFRAG for having developed a comprehensive set of draft European Sustainability Reporting Standards within a relatively short period of time. We acknowledge the hard work of the many individuals involved that has been done to develop the suite of standards as envisaged under the Corporate Sustainability Reporting Directive, including several of our members.

International comparability and alignment

We are pleased to note that paragraph 37 of the preamble to the CSRD[1] provides that "*Standards of the European Union should take account of any sustainability reporting standards developed under the auspices of International Financial Reporting Standards Foundation. To avoid unnecessary regulatory fragmentation that may have negative consequences for undertakings operating globally, European standards should contribute to the process of convergence of sustainability reporting standards at global level, by supporting the work of the International Sustainability Standards Board (ISSB). European standards should reduce the risk of inconsistent reporting requirements on undertakings that operate globally by integrating the content of global baseline standards to be developed by the ISSB, to the extent that the content of the ISSB baseline standards is consistent with the EU's legal framework and the objectives of the European Green Deal.*".

In this regard we appreciate the European participation in the Jurisdictional Working Group established by ISSB and urge both the ISSB and European representatives to use this channel to meet this CSRD stipulation to the maximum extent possible.

1 CSRD-consolidatedtext-final_EN.pdf (europa.eu).

We have also submitted comment letters to the ISSB regarding their draft standards IFRS S1 and S2 in which we have expressed similar comments, and also urging the alignment of terminology for items that are synonymous. Even where disclosure requirements are similar, the different architecture, different terminology (incl. different definitions) and different objectives of the disclosure requirements should be considered in achieving the maximum degree of alignment possible.

We also note that the GRI has recently published a mapping document, which shows significant deviations of the draft ESRSs from the GRI standard. As GRI standards have, to date, been applied by relatively many EU entities reporting under the NFRD, we join the GRIs call[2] for EFRAG to "review some of the detailed requirements and consider making them reporting recommendations or guidance, in line with GRI. In particular, the detailed requirements in the application guidance for all draft ESRSs and those within topical standards for reporting on General, Strategy, Governance and Materiality Assessment, and on Policies, Targets, Action Plans and Resources, which in combination with the requirements in the cross-cutting standard add significantly to the reporting burden."

Five implementation challenges pertaining to the European Sustainability Reporting Standards

Granularity of disclosure requirements: As mentioned in our opening remarks above, we believe that the practicalities of dealing with the level of granularity proposed currently will pose a huge challenge in terms of implementation to all entities required to report in compliance with EFRAG's suite of standards as currently drafted - especially within the tight timeframes set by the CSRD.

We urge EFRAG to seek a pragmatic solution to address the potential level of burden on reporting entities to ensure that the quality of future European sustainability reporting will not be compromised from the outset. In this context, we are also not convinced that users will benefit for overly granular disclosures, when these serve to detract from key messages. As we note below, overly prescriptive requirements carry the danger that the reporting entity may focus on compliance (i.e., adopt a box ticking mentality) rather than on identifying the relevant aspects upon which it should report (and address internally, in terms of "integrated thinking"). We are not suggesting that the level of granularity

[2] GRI's letter dated 30 June: gri-s-submission-to-efrag-s-public-consultation-on-the-first-set-of-draft-esrs.pdf (globalreporting.org).

currently proposed may necessarily remain unsuitable in future but urge more focus to be given to key matters at the start. In this context we note a tendency for the application guidance to add further granularity by specifying in more detail the information to be disclosed in complying with a specific requirement. We urge EFRAG not to "extend" disclosure requirements within the application material, instead it should ensure that the requirement itself is sufficiently clear.

Whilst we fully support the fact that EFRAG is specifically consulting on the issue of phasing-in options for the draft European Sustainability Reporting Standards, as explained above, we urge consideration of a phasing-in approach whereby corporate sustainability reporting would initially focus on key disclosures, with further granular disclosure requirements gradually introduced over time. This could be achieved either by being governed in the ED ESRSs once finalized or as and when EFRAG reviews and revises its standards. The groundwork has been done, so we urge EFRAG to look at identifying the key disclosure matters as it finalizes this first set of European Sustainability Reporting Standards.

In our detailed responses to the Consultation Survey questionnaire, we suggest ways in which a phasing-in approach might be achieved in regard to individual standards.

Complexity in regard to materiality determinations and disclosures: We fully agree that compliance with ESRS shall require reporting entities disclose all material information on their sustainability-related impacts, risks and opportunities in accordance with applicable ESRS (ED ESRS 1.3). We also agree that to achieve understandability it is essential that this disclosed information is not obscured by the disclosure of immaterial matters (ED ESRS 1.40).

Whilst we acknowledge that it may be necessary to include additional (immaterial) disclosures stemming from local legislation – and that these shall be provided in a way that avoids obscuring material information – we do not agree that reporting entities may include immaterial disclosures stemming from generally accepted sustainability reporting pronouncements of other standard setting bodies and non-mandatory guidance including sector-specific guidance in the way EFRAG proposes be "allowed" under ED ESRS 1.147 in combination with ESRS 1.40. We suggest that EFRAG clearly state that only material disclosures stemming from sources other than local legislation are permitted in compliance with the ESRSs.

In any case, additional guidance is generally needed to support the implementation of double materiality, which is an ambitious and extensive new step for reporting entities and assurance practitioners to address; in particular, the process of determining material information is not sufficiently clear.

As a general comment, clarification as to the consistency /coherence of "financial materiality" as defined in ESRS 1.53 with the established financial statement application of materiality is needed. As materiality is a such key issue for sustainability reporting, we suggest EFRAG strive to attain the maximum degree of convergence wit international initiatives and clearly explain the remaining differences to stakeholders.

In this context, we also refer to our comments in which we explain why we suggest that EFRAG:

- reduce the granularity of requirements and add guidance as to how to apply the rebuttable presumption if this approach is retained and for it to be effective, and
- clarify that the disclosure of any additional entity specific information shall relate solely to material information and to revise ED ESRS 1.47 in this respect.

Ability to obtain reliable value chain information: In the absence of data of sufficient quality from within an entity's value chain (e.g., pollution-related information such as that required by ED ESRS E2.35) we do not believe using approximations as required by ED ESRS 1.67 can necessarily, in every case, meet the qualitative characteristics, especially, but not limited to, that of faithful representation. In regard to Scope 3 emissions however, our members note that the estimation techniques currently available and in use may generally be considered suitable for providing a reasonable approximation of a reporting entity's value chain Scope 3 emissions. We suggest the EFRAG clarify that the need to omit information on Scope 3 disclosures should be the exception and would seldom be used in practice, as we do not believe that the omission of disclosures on significant categories of Scope 3 emissions will often be justified. We also suggest that guidance on the use of (suitable) estimation techniques would be helpful. In our responses to the Consultation Survey questionnaire, we also suggest EFRAG consider a phasing-in approach in the context of value chain information i.e., that individual standards allow more time before requiring reporting of information that will have to be obtained from within the reporting entity's value chain. As a minimum, we suggest the standards provide additional clarification of the interaction between qualitative characteristics as this would be helpful for reporting entities when they have to decide whether to use approximations – or even whether to omit one or more required disclosures.

In this context, whilst we agree with the required disclosures in ED ESRS 1.68, we strongly urge EFRAG to require, in addition, the disclosure of the nature of information reported if such information is subject to uncertainty or other inherent limitations. Such clarification is also essential such that users have realistic expectations as to the limitations of reported information for their various decision-making purposes.

Legal restrictions on disclosure: We are also concerned as to the feasibility of certain proposed disclosures, in terms of a reporting entity's ability to comply. For example, ED ESRS G2.38(b). requires the disclosure of "details of ongoing legal proceedings against the undertaking and its employees related to corruption or bribery". Some of the information required to be disclosed under the standards on social matters relating to so-called non-employees may be a further example, especially where personal or sensitive data is concerned. The reporting entity may face legal restrictions such as data protection laws or other confidentiality provisions such that it would not be permitted to make the required disclosures in full and thus unable to fully comply with the standards.

We urge EFRAG to reconsider the pros and cons as well as the usefulness of such disclosure requirements. For example, until the outcome of legal proceedings against the undertaking and its employees related to corruption or bribery is known, speculative disclosures could be misleading and harmful. They may also not be suitable in terms of fulfilling the qualitative charateristics stated in ED ESRS S1. Should such requirements be retained, we urge EFRAG to address this issue such a way that affected reporting entities remain able to comply with the standards e.g., by adding disclosure requirements to cover such eventualities; even when the required information must be omitted.

Entity Specific disclosures: We view the fact that each of the sustainability-related matters prescribed in the CSRD (Article 1 now adds Article 29(b) to Directive 2013/34/EU[3]) has been covered as a significant advantage in comparison to the approach taken by the ISSB, as preparers using EFRAG's standards under the CSRD are not left to decide as to further potential matters upon which to report by reference to the work of others.

This notwithstanding, we are concerned that the proposed requirement in ED ESRS 1.19 ("*For material impacts, risks and opportunities not covered by topical*

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3 See CSRD-consolidatedtext-final_EN.pdf (europa.eu).

Standards and therefore not mandated, the undertaking shall develop disclosures (entity-specific disclosures). They shall meet the characteristics of information quality: relevance, faithful representation, comparability, verifiability, and understandability.") introduces significant challenges in practical application. Whilst we acknowledge that this approach is conceptually sound, we are concerned both from a reporting and assurance perspective that without a firm definition of the term "sustainability matters" it may be particularly difficult to determine the completeness of disclosed information reported in accordance with this provision.

We therefore urge EFRAG to clearly define the range of topics to be considered in the assessment of double materiality (including the need for entity-specific disclosures); we suggest that this should be limited to those covered in the sector agnostic standards in the first instance as well as being limited to material information on topics that the reporting entity is directly affected by and has a direct impact on.

In terms of entity-specific disclosures, as explained above, we do not agree that reporting entities should also include immaterial disclosures stemming from generally accepted sustainability reporting pronouncements of other standard setting bodies and non-mandatory guidance including sector-specific guidance as EFRAG proposes be "allowed" under ED ESRS 1.147. We urge EFRAG to clarify that potential additional entity specific information should be disclosed only when the reporting entity determines that it is material.

Finalization process

Whilst we support the fact that major consultations on corporate sustainability reporting were run concurrently, this did result in a high volume of material being issued for comment within a relatively short period of time. Although not new to all reporting entities who will fall within the scope of the CSRD, sustainability reporting will be new to many European (including a disproportionate number of German) entities that will potentially be impacted in future. We doubt that many such entities will have been in a position to contribute to the consultation in a meaningful way, or perform a thorough assessment of potential implementation challenges.

We are also concerned that EFRAG will have a relatively short period to finalize these standards before presenting them to the European Commission, which is unfortunate and also not well aligned to the significance of the initiative.

In view of the various concerns we have raised above in relation to implementation and in order to achieve the main goals of corporate sustainability reporting, we would urge EFRAG to focus its finalization work on 1) achieving alignment with the ISSB as it finalizes its international baseline, and 2) paring back (temporarily) some of the detailed disclosure requirements it is currently proposing in the EDs of its topical standards together with introducing a deferral for those requirements relating to information that has to be obtained from others within a reporting entity's value chain.

Whilst having a cost benefit analysis performed subsequent to the issuance of the proposed standards is less than ideal, we acknowledge that a thorough analysis of cost benefits will be helpful in informing the finalization of the European Sustainability Reporting Standards. We question, in particular, whether the relatively high degree of uncertainty and complexity inherent in estimating the potential effects of certain environmental-related matters in monetary terms can actually result in the benefit of disclosure to stakeholders exceeding the burden of calculation on reporting entities. This relates, in particular, to the proposed requirements to disclose the entity's estimated potential financial effects in ED ESRS E1.65, 69, and 73, ED ESRS E2.50, ED ESRS E3.39, ED ESRS E4.67 and ED ESRS E5.53.

In this context, we also refer to our comment above on page 6 of this letter, in which we stress the importance of the disclosure of the nature of information reported when such information is subject to uncertainty or other inherent limitations. We suggest EFRAG consider the need to clarify this in finalising the relevant standards.

<u>Achievement of the EU Commission's intended goals</u>

Besides the practical challenges of implementation for reporting entities that we have mentioned above, we are concerned that the proposed granularity of disclosure requirements will also impact the capability of users to make their own assessments, as the proposed disclosure requirements have a propensity to result in information overload. There are also implications for assurance, should reporting entities be unable to establish the robust systems for data collection and internal control that will be essential to the success of the corporate sustainability reporting initiative from the outset.

The presentation structure of corporate sustainability disclosures needs to allow a reader-friendly presentation that clearly shows an entity's story/journey; arguably more alignment with the TCFD recommendations would be helpful.

We do not entirely agree that the use of the rebuttable presumption approach as currently proposed is suitable, because it introduces unnecessary requirements for which entities would have to "prove" non-relevance whereas a reporting entity's focus in reporting on sustainability-related matters should be on identifying the specifics pertaining to the individual reporting entity, not disproval of the potential relevance of a list of disclosures. For example, certain marine-related matters required to be disclosed under ED ESRS E3 may be a common aspect where a presumption could reasonably be expected to be rebutted. This may be more onerous for smaller, less complex entities than for larger complex multinational corporates. In our opinion, a reduction in the granularity accompanied by guidance might be helpful if the rebuttable presumption approach is retained and for it to be effective.

A key strength of the green deal is that it seeks to steer entities' behavior and investment decisions towards sustainable practices. As explained above, we fear that overly prescriptive requirements carry the danger that the reporting entity may focus on compliance (box ticking) rather than on identifying the really relevant aspects upon which it should report (and address internally in terms of integrated thinking). This is a further reason we urge EFRAG to address this as suggested above, since requirements for key disclosures can lead to changes in behavior, whereas, in contrast, copious detailed disclosure requirements may not.

The IDW has identified the following aspects of the proposals that might lead to counterproductive behaviour.

- Specifically, we question whether the material in ED ESRS 2.AG30 could lead to growing demands from a range of "purportedly" key stakeholders. There may be a propensity for misuse, whereby entities could be "forced" by certain stakeholders to explain their actions, which in turn could lead to ever more radical views etc. being expressed to achieve an individual stakeholder group's political objective(s). In our opinion, clear criteria for determining a boundary for who constitutes a key stakeholder would be helpful, given their role in the reporting entity's materiality determination. This issue has the potential to lead to differences in practical application.

- We also question whether disclosures on key features of the value chain in line with guidance in ED ESRS S2.AG 16 might cause suppliers in the value chain to change their behavior to "avoid" being considered "key" and reported on.

Disclosure of stranded assets could also be considered e.g., in ED ESRS 1.103 et seq. as this could provide useful information to stakeholders.

We also note in general that clear and robust definitions or criteria are essential to minimize interpretation leeway for preparers and for assurance to the extent possible. Clear disclosure of the nature of information reported when such information is subject to inherent limitations is also essential such that users have realistic expectations as to the limitations of reported information for their various decision-making purposes. We discuss both of these issues in more detail below in the section of this letter headed "Assurance".

Assurance

The potential for greenwashing has been well acknowledged. The IDW agrees that independent high-quality assurance has a key role to play in sustainability reporting.

As explained above, entities must have robust data collation and internal control systems to ensure their ability to report information that is reliable and verifiable – and they therefore need sufficient time and resources to develop and mature their systems before a meaningful assurance engagement can be undertaken. Our members are extremely concerned as to this key issue, which may be particularly problematical for smaller entities who currently have little or no experience with reporting on sustainability-related matters and lack the necessary resources and expertise to address this in good time.

The IDW also wrote to the ISSB that the standard setter's role is to establish clear criteria and definitions. This should include robust criteria to support entities' decisions as to when to substitute a theoretically possible disclosure with estimations or to omit required information and when to provide qualitative rather than quantitative disclosures. Disclosure of the nature of information reported when such information is subject to inherent limitations is also essential such that users have realistic expectations as to the limitations of reported information for their various decision-making purposes. It is absolutely crucial for users to be made aware through disclosures in the sustainability report of any inherent limitations in measurement, evaluation or assurance to which such information is subject.

Finally, as EFRAG is aware, the IAASB has agreed to start work on assurance standards. We support further liaison between EFRAG and the IAASB as essential to both in finalizing their respective standards.

Suggestions for further clarification or guidance

We have identified a number of issues where we suggest further clarification or guidance might be helpful.

For clarity, we suggest the requirements should consistently refer to either "key", "significant", "critical importance" or similar when mentioning sustainability-related risks and opportunities and impacts or other sustainability matters or issues and firm criteria are required for reporting entities to determine what constitute matters that are "key", "significant", or of "critical importance".

There is a tension between some requirements and the description of characteristics of information quality.

- For example, how does the balance between the factors "severity" and "the likelihood of occurrence" of an impact, risk or opportunity actually apply in the identification of which impacts, risks and opportunities are disclosed (ED ESRS 2.7 (b) (iii) and ED ESRS 1.51 refer to this only in relation to negative impacts (in contrast the ISSB uses this as part of the materiality ED IFRS S1.57)? We therefore suggest EFRAG address this question and consider whether these terms could be clarified or defined further.
- ED ESRS 1.43 discusses "information materiality" and part (iii) mentions the 'European public good" in relation to transparency as an element of materiality. We are concerned that this concept is overly broad and that its application is unclear and unhelpful in the complex materiality assessment process envisaged by EFRAG. We suggest EFRAG clarify its intentions in this context.

We would be pleased to provide you with further information if you have any additional questions about our response and would be pleased to be able to discuss our views with you.

Yours truly,

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