CHAPTER 1

EFRAG sustainability reporting standards - ESRS

This article aims to:

- Provide a brief overview of the European Sustainability Reporting Standards (ESRS).

Introduction

Globally, ESG reporting is evolving rapidly. Stakeholders are increasingly demanding for transparency in ESG reporting and have high expectations with respect to the quality of ESG disclosures. In view of this, standard setters around the world are developing sustainability reporting frameworks.

In January 2023, the European Union (EU) published the Corporate Sustainability Reporting Directive (CSRD)[1]. This new directive modernises and strengthens the rules regarding the social and environmental information that companies have to report. Through the CSRD, investors and other stakeholders would have access to information needed to assess the impact of companies on people and the environment. As per the CSRD, certain companies are required to provide information regarding the impacts on sustainability matters and how sustainability matters affect a company's development, performance and position. This information would form part of the management report.

In this regard, the European Financial Reporting Advisory Group (EFRAG) developed ESRS reporting standards. The first set of draft standards were introduced in November 2022. Subsequently, on 31 July 2023, the EC published the final text of its first set of 12 ESRSs[2].

The ESRSs have been developed to support the EU Green Deal[3] and to align with the existing sustainability frameworks in the EU e.g. Sustainable Finance Disclosure Regulation (SFDR)[4] and EU Taxonomy. Further, the ESRSs are aligned with the reporting areas used in Task Force on Climate-Related Financial Disclosures' (TCFD) recommendation. Also, many disclosure requirements are similar to or based on the recommendations and the standards developed by Global Reporting Initiative (GRI).

1. The CSRD amends the existing Non-Financial Reporting Directive (NFRD). NFRD is the predecessor of the CSRD and has a more limited scope.
2. The EU Parliament and the EU Council have a period of potentially up to four months to object. If they raise no objections, then the first set of ESRSs will apply for the first companies for 2024 reporting period.
3. The EU has dedicated itself to sustainable development and has set a very ambitious target of making Europe the first climate-neutral continent by 2050. To achieve this ambition, the EU introduced the European Green Deal in 2019, which consists of dedicated regulations, strategies and funding mechanisms that address eight major policy area.
4. SFDR imposes mandatory ESG disclosure obligations for asset managers and other financial markets participants.

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ESRSs published

The 12 ESRSs published are bifurcated as follows:

- **Two cross-cutting standards:** These standards explain the fundamental concepts from the CSRD. They provide general reporting concepts and include overarching disclosure requirements including multiple datapoints. These standards lay down the principles of disclosure, presentation structure and establish transition options, including phasing-in. These standards are:

Standard	Brief description
ESRS 1, *General requirements*	This standard describes the architecture of ESRS standards, explains drafting conventions and fundamental concepts, and sets out general requirements for preparing and presenting sustainability-related information.
ESRS 2, *General disclosures*	This standard establishes Disclosure Requirements (DRs) on the information that a company should provide at a general level across all material sustainability matters on the reporting areas such as governance, strategy, impact, risk and opportunity management, and metrics and targets.

(Source: KPMG in India's analysis read with ESRS issued on 31 July 2023)

- **Ten topic-specific ESRS:** These standards lay down the disclosure requirements on environmental, social and governance topics. They establish metrics and explain how to disclose related targets for each topic. The standards are:

Category	Topic
Environment	ESRS E1, *Climate change* ESRS E2, *Pollution* ESRS E3, *Water and marine resources* ESRS E4, *Biodiversity and ecosystems* ESRS E5, *Resource use and circular economy*
Social	ESRS S1, *Own workforce* ESRS S2, *Workers in the value chain* ESRS S3, *Affected communities* ESRS S4, *Consumers and end-users*
Governance	ESRS G1, *Business conduct*

(Source: KPMG in India's analysis read with ESRS issued on 31 July 2023)

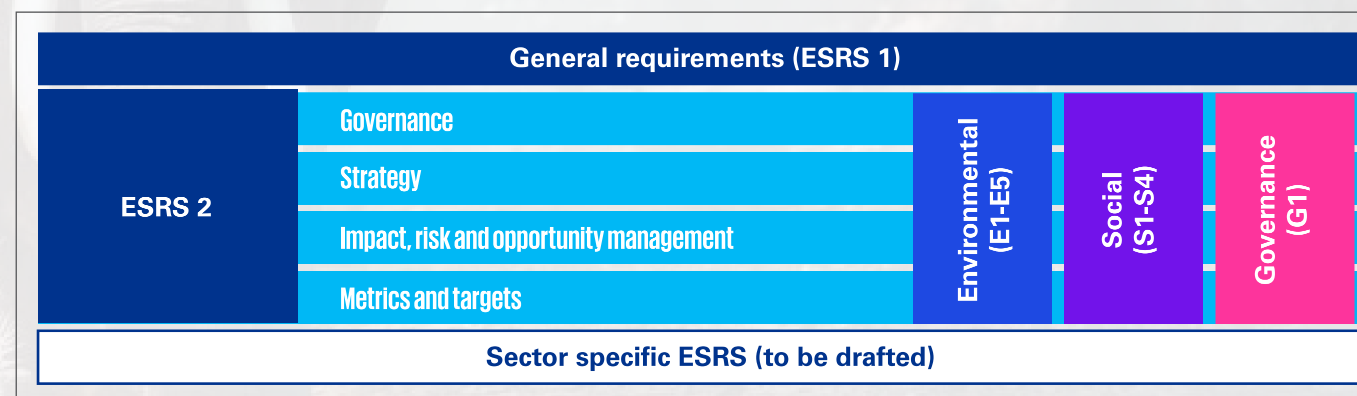
As per the above-mentioned 12 ESRSs, companies should provide information on their:

a. Governance and strategy to address material sustainability topics,

b. The impacts, risks and opportunities arising from those topics and

c. Quantitative metrics and targets.

The cross-cutting standards and topical standards are sector-agnostic i.e. they apply to all companies regardless of which sector or sectors the company operates in. Further, it is important to note that, EFRAG will publish additional sets of ESRS in due course of time which will include sector specific standards to address the sector specific requirements.



(Source: KPMG IFRG Limited - high level overview 'Get ready for European Sustainability Reporting Standards' dated 1 August 2023)

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Key elements of the standard

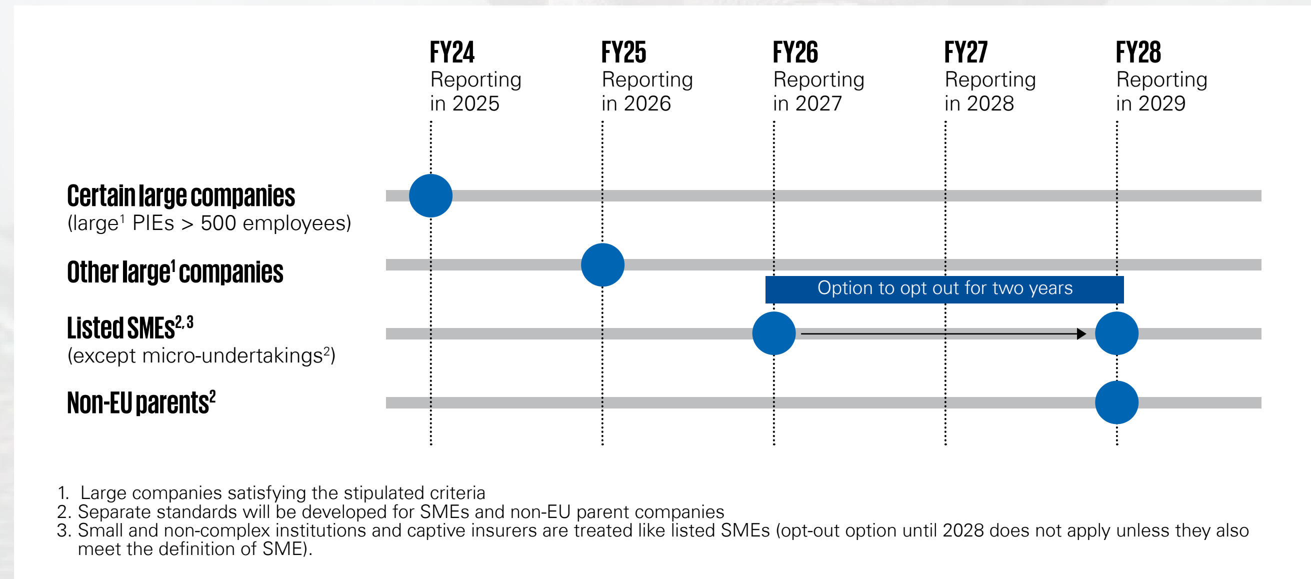
I. Effective date

The effective date for applicability of ESRS is from 1 January 2024 i.e. reporting would take place in 2025. ESRS would apply in a phased manner beginning with Public Interest Entities (PIEs) and companies with listed securities on EU-regulated markets which are large and have more than 500 employees (e.g. those that are already subject to reporting requirements under the Non-Financial Reporting Directive (NFRD)).

II. Scoping requirements

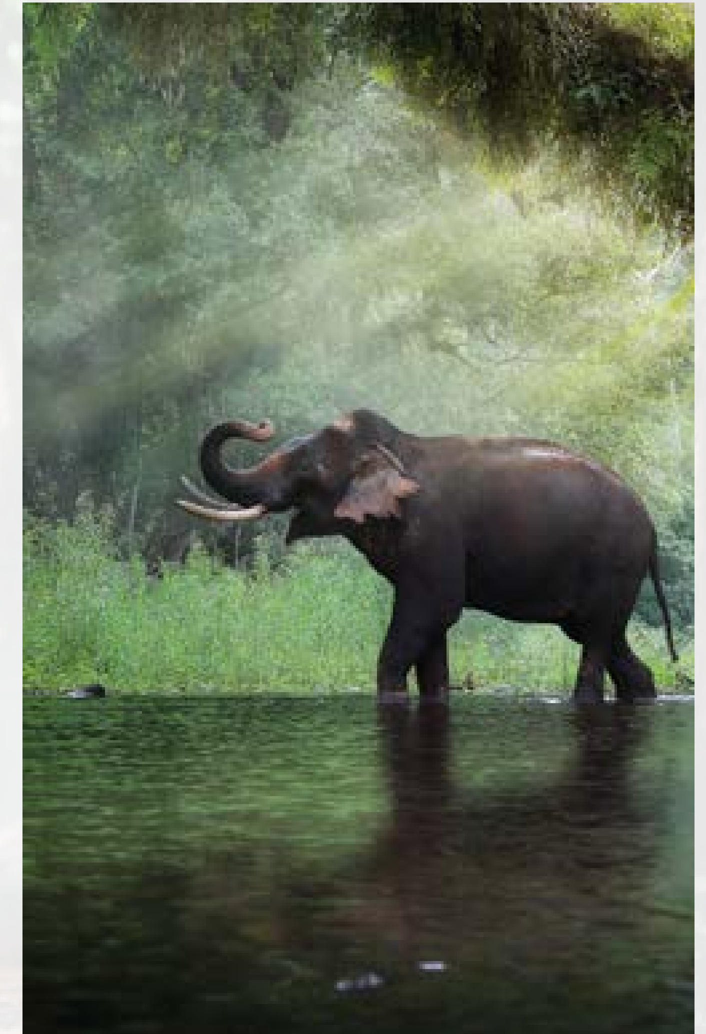
The ESRS would apply to (group exemptions may apply):

- Large EU companies which on the balance sheet date, exceed two of the following three criteria (including EU and non-EU subsidiaries):
  a. 250 employees or
  b. Net revenue of EUR 40 million or
  c. Total assets of EUR 20 million.
- Companies with listed securities on EU-regulated markets (except micro-undertakings[5]); and
- Ultimate non-EU parent companies[6] with a combined group turnover in the EU of more than EUR 150 million.



1. Large companies satisfying the stipulated criteria
2. Separate standards will be developed for SMEs and non-EU parent companies
3. 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).

(Source: KPMG IFRG Limited - high level overview 'Get ready for European Sustainability Reporting Standards' dated 1 August 2023)



5. 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.
6. Separate standards will be developed for SMEs and non-EU parent companies.

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III.Non-EU parent entities

A non-EU parent will have to report on the sustainability impacts at the group level of that non-EU company if the non-EU companies generates over EUR 150 million per year in the EU **and** that has in the EU either a branch with a turnover exceeding EUR 40 million or a subsidiary that is a large company or a listed SME.

Thus, such a non-EU parent company will have to report on the sustainability impacts at the group level from financial year 2028 i.e. first sustainability statement to be published in 2029. Separate disclosure standards would be developed for such non-EU parent companies. Further, CSRD also provides certain reporting exemptions to such Non-EU parent companies. One such exemption provided is - until 2030 EU subsidiaries of non-EU parent companies could choose to prepare consolidated sustainability report including all those subsidiaries that would be obliged to report independently of the remaining group due to size or listing status.

It is important to note that, any subsidiary that meets the scoping requirements, as stipulated in the previous section, is nonetheless in scope and the related disclosures that apply to an EU-based company would also apply to such a subsidiary.

IV.Assessment of materiality

Performing a materiality assessment is necessary for the company to identify the material impacts, risks and opportunities to be reported.

- **Concept of double materiality:** The company should report sustainability matters based on the double materiality. Double materiality refers to two dimensions of materiality - 'financial' and 'impact'. As per the standard, companies are required to perform materiality assessments for both dimensions. Therefore, a sustainability matter would meet the criterion of double materiality if it is material from either of the dimension.

Impact materiality

- Under the ESRSs, impact materiality will require disclosure of sustainability-related 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 a company needs to consider to assess impact materiality.
- This assessment includes impacts in a company's upstream and downstream value chain.
- Materiality will be assessed based on severity and likelihood of the impact.

Financial materiality

- Under the ESRSs, financial materiality will require disclosure of sustainability-related 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 will not be limited to matters within the company's control.
- Materiality will be assessed based on likelihood and (potential) size of the financial effect.

(Source: KPMG IFRG Limited - high level overview 'Get ready for European Sustainability Reporting Standards' dated 1 August 2023)

The standards also emphasise that the engagement with stakeholders is central to assessing materiality. Further, for a proper understanding of the material impacts, risks and opportunities, the company should consider disaggregating the reported information.

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- **Exception to materiality assessment test:** It is important to note that, irrespective of the outcome of the materiality assessment, the company should always disclose the information required by ESRS 2[7]. All the other standards and the individual disclosure requirements and datapoints within them are subject to a materiality assessment, but when companies conclude that ESRS E1 (climate change) is not material, they should provide a detailed explanation of their conclusion. In case of the company concludes that a topic other than climate change is not material and omits all the disclosure requirements in the corresponding topical ESRS, it may provide a brief explanation of the conclusions of its materiality assessment for that topic.

V. Phase-in reliefs

Certain reliefs have been introduced to reduce the reporting burden on companies:

Relief year	Nature of relief
Year 1 - 2	• Comparative information is not required to be disclosed in Year 1 • All companies, regardless of size, may opt out of disclosing the expected financial impacts related to risks from environmental issues for the first year of reporting. Companies can provide qualitative disclosure only on these financial impacts for further two years. • Certain disclosures related to own workforce (social protection, people with disabilities, work-related illnesses and work-life balance) can be omitted in the first year of reporting. • Companies with less than 750 employees may also omit: a. the disclosure of Scope 3 greenhouse gas emissions (ESRS E1) and other disclosures on their own workforce (ESRS S1) in the first reporting year; and b. the disclosures on biodiversity (ESRS E4 Biodiversity and Ecosystems), workers in the value chain (ESRS S2 Workers in the Value Chain), affected communities (ESRS S3 Affected Communities) and consumers (ESRS S4 Consumers and End-users) in the first two reporting years.
Year 1-3	• Other available frameworks could be used to develop relevant disclosures on material sustainability-related matters in advance of sector-specific standards • Information on value chain is not required to be estimated and could be omitted if the information is not available. However, this relief is not applicable to datapoints relevant for other EU laws or based on internal information. It includes both upstream and downstream information. • Company-specific disclosures developed prior to initial application may continue to be used.

7. All the Disclosure Requirements and data points specified in ESRS 2 should be disclosed. Also, mandatory disclosure is required for the Disclosure Requirements (including their datapoints) in topical ESRS related to the Disclosure Requirement IRO-1 Description of the process to identify and assess material impacts, risks and opportunities, as listed in ESRS 2 Appendix C Disclosure/Application Requirements in topical ESRS that are applicable jointly with ESRS 2 *General Disclosures.*

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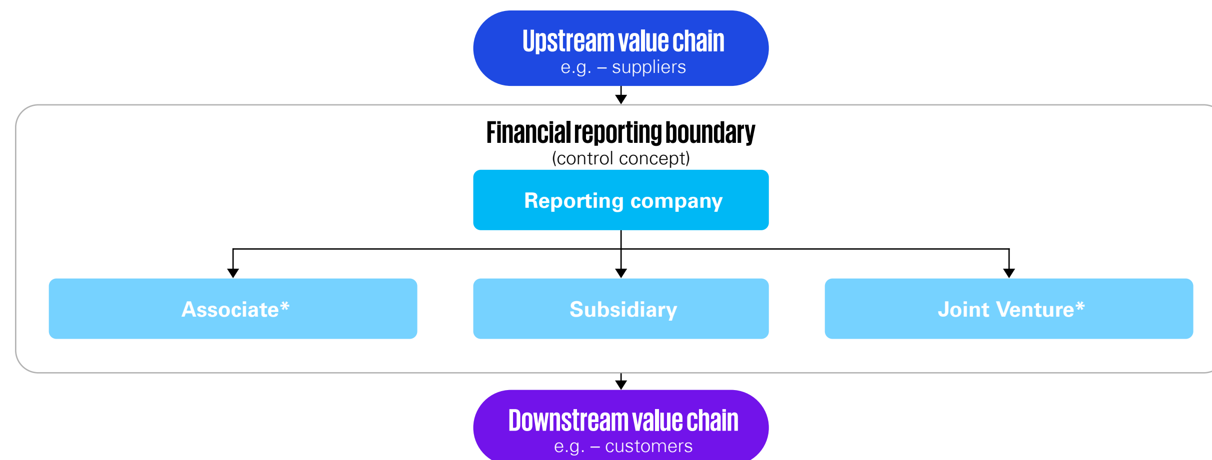
VI. Reporting boundary and value chain

The ESRS reporting boundary is based on the financial statements. In other words, the sustainability statement would be prepared for the same reporting company as the financial statements. For example, if the reporting company is a parent company which is required to prepare consolidated financial statements, then the sustainability statement will be prepared for the group.

While preparing the sustainability statement, the companies are required to identify and report on material impacts, risks and opportunities through its direct and indirect business relationships in the upstream and/or downstream value chain. The ability to obtain the necessary data would depend on various factors - e.g. the contractual arrangements in place and the level of control over the value chain.

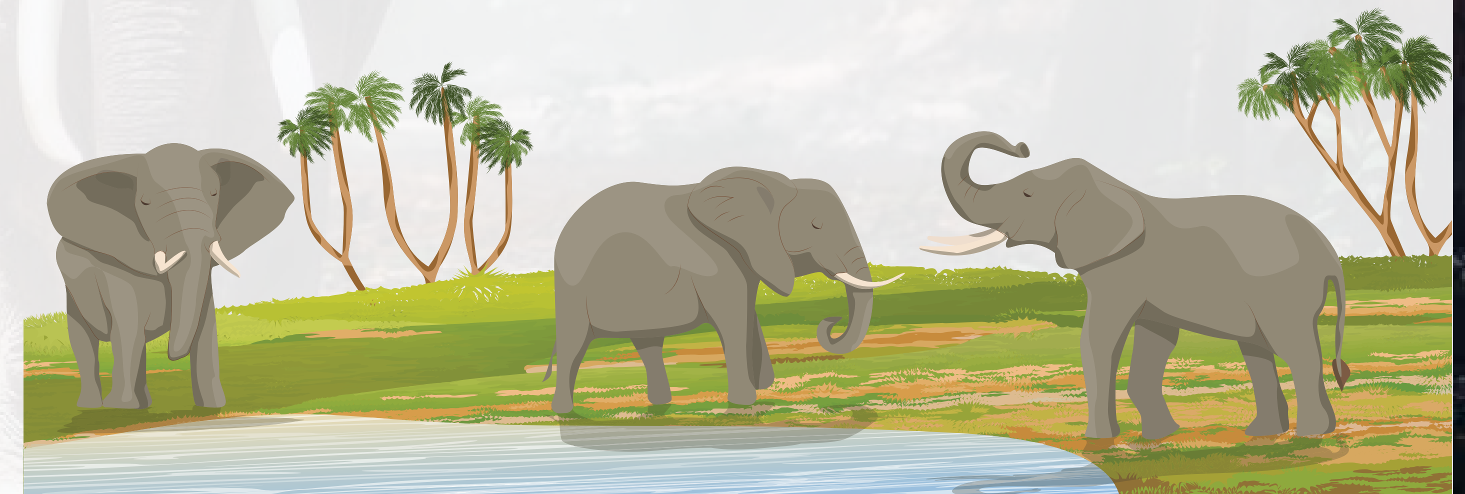
If information from the value chain is not available, then a company will use estimated data using all reasonable and supportable information. In the first three years of application, the ESRSs will allow transitional measures if information cannot be obtained.

The below diagramatic representation provides an overview of the reporting boundry and the consideration of the value chain aspects:



(Source: KPMG IFRG Limited - high level overview 'Get ready for European Sustainability Reporting Standards' dated 1 August 2023)

As seen in the diagram, when associates or joint ventures, are accounted under the equity method or proportionally consolidated in the financial statements, are part of the parent company's value chain then the suppliers and customers of the parent company should include information related to those associates or joint ventures in accordance with the approach adopted for other business relationships in the value chain. Thus, while determining the impact metrics, the data of the associate or joint venture would not be limited to the share of equity held, but rather the parent company should take into account the basis of the impacts that are connected with the parent company's products and services through its business relationships.



VII. Reporting timelines

Companies in scope will prepare a sustainability statement including the disclosures required by the ESRSs as part of their management report which is to be published at the same time as the financial statements.

VIII. Reporting on policies, action plans and targets

Companies should provide granular disclosures about their policies, action plans and targets across all material topics. It is important to note that the standards themselves do not require companies to put in place new targets or implement new policies but rather the standards would bring greater visibility and scrutiny of the company's plans.

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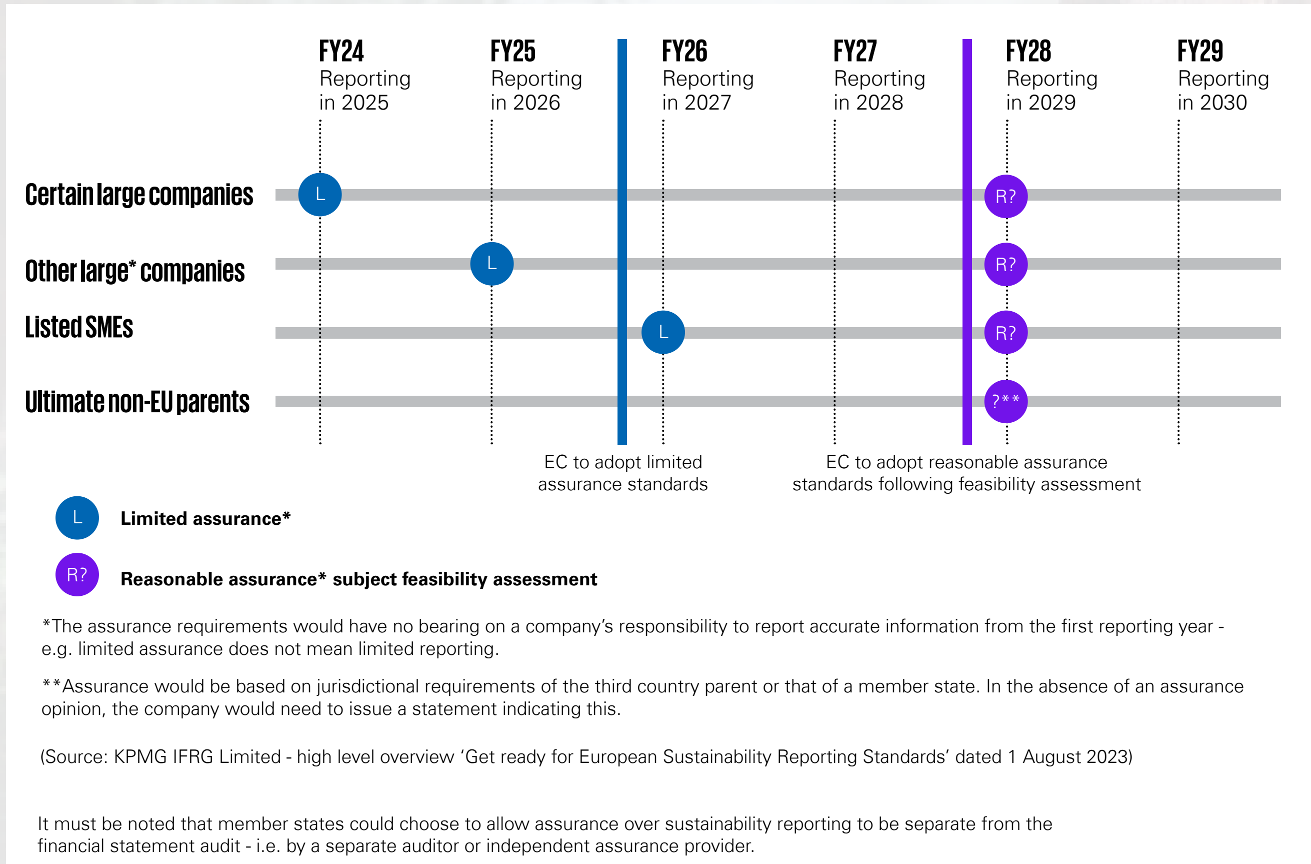
IX. Assurance

CSRD requires assurance across all topics in the following manner:

a. Limited assurance[8] would be applicable from the date of initial reporting

b. Gradually reasonable assurance[9] would be applicable from a future date.



*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.

**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.

(Source: KPMG IFRG Limited - high level overview 'Get ready for European Sustainability Reporting Standards' dated 1 August 2023)

It must be noted that member states could 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.

8. 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').
9. Expressing reasonable assurance requires the assurance provider to obtain sufficient appropriate evidence to conclude that the sustainability-related information is prepared, in all material respects, in accordance with the applicable reporting criteria (positive conclusion).

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Consider this

As the ESRSs would apply from 2024, scoped in companies should consider the following points with respect to the implementation of the new sustainability reporting standard

Understand the impact

The management of companies should conduct necessary research to understand when, where and how the CSRD scoping requirements would apply to the company and the wider group. They must also understand and assess the deviations between ESRSs and any existing sustainability reporting standard.

Determination of materiality

The scope and breadth of the company's value chain should be identified. Further, the management should undertake a double materiality assessment to determine which topics are relevant to report on and decide what information is material about those topics from an impact and financial perspective.

Maturity assessment

Maturity assessment should be conducted with respect to the processes, the control environment, data model and policies. Also, the management should understand the current distribution of roles, available knowledge and capacity.

Transform reporting

The management should design the manner of reporting which would include designing the most efficient reporting structure to meet group and individual company needs. For this purpose, companies should develop and deploy target operating model, including training as well as support for change management.

Assurance consideration

As assurance requirements would be applicable, companies should assess the control environment, data quality and availability of sufficient documentation to support assurance. Any existing issues should be rectified in advance.

Bottom line

Regulators and standard setters globally are issuing standards requiring companies to include sustainability-related disclosures in the annual reports. Recently, the International Sustainability Standards Board (ISSB), on 26 June 2023, issued the global sustainability disclosure standards - IFRS S1, *General Requirements for Disclosure of Sustainability-related Financial Information* (IFRS S1) and IFRS S2, *Climate-related Disclosures* (IFRS S2) which would put sustainability reporting on an equal footing with financial reporting and facilitate the much-needed connectivity between sustainability-related financial information and the financial statements. The US Securities Exchange Commission (SEC) has proposed climate-related disclosures. However, there is a need for consistent and comparable information. For this purpose, the EC, EFRAG and the ISSB are working towards alignment and interoperability between ESRS and the ISSB Standards.

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