Deutsches Aktieninstitut

Europe's new Corporate Sustainability Reporting Directive – Involving companies to ensure a successful transition to a sustainable economy!

Feedback on the Proposal for a Corporate Sustainability Reporting Directive, 14 July 2021

Introduction

Climate change and the necessary transition to a resource-conserving and climate-neutral economy require a comprehensive transformation process. Not only production processes and operational organizations, but also corporate business models must be put to the test in order to achieve the goal of net zero greenhouse gas emissions by 2050. Companies are already doing their part to achieve this goal. They are aware of their responsibility and are also acting out of their own interests. After all, in order to survive and be successful in the future, social acceptance of corporate action is indispensable (License to Operate).

Sustainable economic activity will also be a necessary prerequisite for sound corporate financing in the future. For many investors, and in particular large international investors, a company's compliance with ESG criteria is now a decisive condition for their investment.

The new reporting obligations for companies contained in the new Corporate Sustainability Reporting Directive are intended to ensure that investors are in a position to make investment decisions on a pro-sustainability basis. This intention is principally welcome. Companies also have an interest in presenting their progress in the sustainability transformation process and being measured against it. However, additional transparency, documentation and reporting requirements must not overwhelm companies. The costs and benefits of reporting requirements must be carefully examined, weighed up and defined. The goal must not be more and more reporting obligations, but better and more precise requirements.

The new Corporate Sustainability Reporting Directive, together with other reporting regulations, such as the delegated act of Art. 8 of the Taxonomy Regulation and the other delegated acts beyond, as well as the European sustainability reporting standards still to be developed by the European Financial Reporting Advisory Group (EFRAG), will lead to a very complex and completely new reporting system. These complex structures have been and are being developed at top speed and will present companies with implementation challenges. Their practical testing has so far come up far too short. The time required to implement the corresponding additional processes (e.g. IT processes, reporting lines) within the companies will also be foreseeably short.

Deutsches Aktieninstitut encourages the EU Commission to embrace the following points:

1) Consideration of the "preparer perspective" essential

The real economy must be given at least half of the seats in the EFRAG Sustainability Reporting Board and committees to be formed in the European standard development process. Companies have so far been insufficiently involved in the European initiatives on the EU Taxonomy and further sustainability reporting requirements that affect them. This shortcoming must not be repeated in the development of the planned standards.

2) The goal must be an international standard

a. Sustainability reporting must follow a legally secure, consistent, flexible and proportionate framework pursuing the objective of simplicity. Such a framework must be embedded in an internationally recognized reporting landscape and build on internationally accepted standards. Due to their broad international acceptance, the specifications of the international Global Reporting Initiative, TCFD and the Value Reporting Foundation in particular should be reflected in the new standards to be developed. Furthermore, the EU Commission and EFRAG should closely collaborate with the IFRS-Foundation, which intends to set up a sustainability standards board aiming at achieving an international/global consolidation of reporting rules.

b. In its CSRD draft, the EU Commission emphasizes the importance of initiatives for a common international standard. A clear commitment however is missing as to how it will be ensured that companies operating internationally do not end up having to follow one European and one international standard. The desired goal of consolidating EU reporting standards and frameworks must not be jeopardized by a permanent insistence on European standards. An adequate mechanism should be implemented from the beginning to enable the transposition of international standards into EU law.

3) Retain Member State option to publish in a separate report

a. The new CSRD leads to a change in the nature of the management report. Currently, the management report addresses investors/capital providers. Due to the sustainability information to be reported, the range of addressees will be significantly expanded to include civil society and also the general public. Against the background of the principle of double materiality, which will have to be followed under the new directive, the establishment of a filtering process should be considered - especially with regard to the inside-out perspective. This should

help companies to identify the material aspects to be reported across all addressed (heterogeneous) groups. This should also find its way into the reporting standards to be developed by EFRAG.

b. By reporting on double materiality, sustainability reporting threatens to marginalize the financial figures in the management report by the sheer mass of information alone. This also refers to potential and actual impacts of companies along the entire value chain. The European legislator must respond to this with focused reporting requirements.

c. We are in favour of the CSRD continuing to allow member states to give reporting companies the option of publishing a separate sustainability report. Many companies produce separate sustainability reports that present voluntary and mandatory information together and thus provide a high benefit for their readers.

4) Limit scope of application

The extension of the scope of the CSRD to all listed companies with the exception of micro-entities is problematic in view of the simultaneous inclusion under Article 8 of the Taxonomy Regulation. The reporting obligation under the Taxonomy Regulation is highly complex and currently poses application problems and uncertainties for both reporting companies and investors. It would be completely disproportionate to burden small and medium-sized companies with this reporting obligation.

5) Secure legal framework

European requirements that find their way into various sustainability initiatives without a prior coordination within in the EU Commission are problematic because they lead to contradictions and disproportionate burdens for companies. They cause confusion on both the corporate and the investor side and must be avoided. Open legal and comprehension issues within the new CSRD and in relation to other regulatory projects, such as the EU Disclosure Regulation and the EU Taxonomy, should be clarified quickly.

6) Sound governance structure of the standard setter and realistic timeframe

The decision to appoint EFRAG as standard setter requires a well-considered governance structure and adequate resources for EFRAG to fulfill its new role in the best possible way. In addition, the timeframe for the standard to be developed and the implementation by the entities must be set realistically. In particular, the timeframe for standard setting until October 2022 is clearly too short and needs to be extended in order to implement the necessary procedures among others as

regards data collection of new KPIs. It should be taken into account that many smaller and medium-sized listed companies will be required to prepare a sustainability report for the first time.

Companies should also be given sufficient time to implement the new reporting standard and build a robust reporting structure. This requires a formalized standard-setting procedure ("due process") with clearly defined process steps. The IFRS Foundation's standard-setting process for financial reporting should serve as a model.

If the very ambitious schedule is adhered to, the reporting requirements should be limited to the climate topic.

7) Postpone tagging

The electronic tagging of sustainability data should be postponed and initial experience with the tagging of financial indicators should be awaited. In view of the more complex sustainability reporting, which will have significantly more narrative parts, this seems imperative.

In the case of a future introduction, it should be considered that the tagged sustainability information should make use of the identical methodology of the financial reporting in order to increase the acceptance for the implementation and administration effort and to minimize the effort.

In detail

1. Consideration of the "preparer perspective" is essential

In the European standard development, the involvement of the real economy in the relevant EFRAG bodies must be ensured by allocating at least half of the seats to companies.

The new CSRD establishes new reporting obligations for companies. It is therefore imperative that reporting companies are involved in the detailed design of the directive - especially in the EU reporting standards to be developed by EFRAG. In the legislative processes for the Non-Financial Reporting Directive as well as for the Taxonomy Regulation, the concerns of companies have not been sufficiently taken into account. In the technical expert group on sustainable finance formed at EU level, which played a key role in the detailed work on the EU Taxonomy, there were only two company representatives among 35 experts. The picture is similar for the Platform on Sustainable Finance, which began its work last October and is intended to advise the EU Commission on sustainability issues and further develop the

taxonomy. Here, companies of the manufacturing industries are also underrepresented (fewer than 5 out of 50 members). As a result, the requirements are difficult to apply in practice and require a great deal of effort. There is also a risk that the financing of the transformation processes of the European economy towards a CO2-neutral economy will fail, because this is not sufficiently addressed within the taxonomy.

A lot more company representatives must therefore be appointed to the expert groups to be formed, as a successful transformation process cannot succeed without companies. This is the only way to ensure that the legal requirements can be implemented in a practicable manner on the company side. Companies contribute to the development of new standards with motivation and expertise as they pursue sustainability goals in their own best interest. Furthermore, there is an increasing demand for sustainability information among investors, customers and consumers, among others.

In addition, however, an appropriate due process and involvement via public consultation processes are also particularly relevant. The future EFRAG set-up should definitely ensure this.

2. The goal must be an international standard

For companies and investors/users alike, clear, consistent, clearly understandable and legally compliant sustainability reporting is of key importance. From a company perspective, reporting must follow a flexible and proportionate framework that does not confront companies with insurmountable challenges and allows them to report closely in line with their business model. Investors need reliable information to base their investment decisions on. Correspondingly, companies have an interest in avoiding legal risks (such as liability issues and related legal proceedings) through inaccurate or ambiguous reports.

Globally active companies and investors also need regulations that are as consistent as possible on the international level. Therefore, the standards that sustainability reporting should follow must be within a consistent, coherent, clear and internationally embedded framework. In doing so, the EU should not create additional independent reporting standards for sustainability reporting, but should ensure maximum alignment with international standards.

To avoid global companies having to comply with both European and international standards, the EU Commission should explain how it intends to avoid a permanent coexistence of European and international standards. Future European standards will otherwise counteract the CSRD's declared goal of leading to consolidation in the field of standards. To this end, the EU standard setter should be embedded in a global standard setting environment and cooperate with the IFRS Foundation.

With regard to the directives and regulations affected (such as the CSRD, Taxonomy Regulation and Disclosure Regulation) as well as for the European reporting standard to be developed, contradictions and ambiguities must be avoided in order to prevent obstacles to the promotion of sustainable and long-term climate-neutral investments. In order to reduce the complexity of sustainability reporting, all existing requirements should be scrutinized during the development of the standards and the set of necessary reporting requirements should be kept lean.

3. Retain member state option to publish in a separate report

In terms of its function, a company's management report is aimed at investors. The new CSRD reporting requirements will change its nature. The new sustainability reporting requirements expand the range of addressees of the management report to include a large number of stakeholder groups that are on an equal footing with the providers of capital. In combination with the double materiality/materiality – above all the inside-out perspective – companies subject to reporting requirements will in future likely be confronted with an almost unmanageable number of reporting topics or reporting spheres.

The CSRD proposal provides little guidance here and presumably leaves further clarification to the standard-setting process without, however, clearly formulating this. It is essential to think about a filtering process to identify overarching reporting topics that are relevant for all stakeholder groups.

There is also a risk of an imbalance between financial indicators and sustainability information in the management report, as the latter must be reported in great abundance. The European legislator must counteract this with focused reporting requirements.

In principle, we believe that the CSRD should also give member states the option of allowing reporting companies to publish sustainability information in a separate sustainability report. This does not counteract a flooding of the management report with sustainability information and an audit with limited assurance. Apart from this, many companies prepare separate sustainability reports in which they present voluntary and mandatory information together. This is of great benefit to the reader.

4. Limit the scope of application

Extending the scope of the CSRD to all listed companies with the exception of micro-enterprises is problematic. On the positive side, the EU intends to develop its own leaner reporting standards for the small and medium-sized companies that are now included in the reporting obligation. However, by being included under the CSRD, companies will also be subject to the Taxonomy Regulation at the same time. This presents SMEs with problems that are almost impossible to solve, as the EU

Taxonomy in its current version is neither final nor tested in practice. Due to the difficulties associated with the application of the EU Taxonomy, SMEs should be released from the obligation to report in accordance with the taxonomy at the present time. This would also serve the EU Commission's objective of facilitating SMEs' access to the capital market.

5. Secure legal framework required

Open legal questions arising from the new CSRD must be clarified quickly. These include, for example, the question of why the new reporting requirements also apply to intangible assets. If, as suggested in Recital 28, the intention is to close the gap between book and market value, this would be an issue to be clarified in the context of financial reporting and not sustainability reporting. If the Commission has a different intention, it must explain and justify this.

Reliability of the rules is also of great importance for a secure legal framework. The EU Commission's proposal to review and adapt the rules of the CSRD in a regular cycle of three years harbors the danger of a constant change in the law. This leaves little time for companies to adopt the new requirements and make their own adjustments based on experience. The evaluation should therefore take place over longer periods of time.

Furthermore, with regard to the audit, the question arises as to how, in the case of an integrated report, the reported sustainability information is to be integrated by the auditor with "limited assurance", even if other components of the integrated report are audited with "reasonable assurance". This seems to be efficiently implementable only with the option of a closed chapter, as also foreseen in the CSRD. Companies need clarity on this at an early stage.

The requirement for information on future impacts is very vaguely formulated. Forward-looking disclosures are problematic because they are questionable from a legal point of view and for reasons of a "clean" audit. This applies to both "limited assurance" and "reasonable assurance".

The costs associated with the audit cannot be predicted at present, as it is not clear what additional data will be required in the future and whether new internal systems will have to be set up within the companies. Audit costs for additional data will be incurred in any case.

6. Standard setting requires solid structure and realistic timeframe

The development of European sustainability reporting standards is a central component of the new CSRD. The standards to be developed by the European Financial Reporting Adivisory Group (EFRAG) are to be translated into delegated acts by the EU Commission and thus become mandatory for companies. This task poses major challenges for EFRAG, as it is currently primarily a technical evaluator

of the standard framework for financial reporting. At the IFRS Foundation, EFRAG also ensures that the European perspective is taken into account in IFRS' (further) development. It also advises the European Commission on the adoption of IFRS into EU law (endorsement process).

The further development of EFRAG into a standard setter for non-financial reporting standards requires not only a well-considered expansion/change in EFRAG's governance structure, but also appropriate funding. It will take time to have both in place. However, a first set of the sustainability reporting standards to be developed should be adapted by the EU Commission as early as October next year. In such a short period of time, however, it will hardly be possible to develop a high-quality reporting standard.

In financial reporting, for example, standard development at the IFRS Foundation regularly takes more time, although it is the responsibility of full-time staff. At EFRAG, however, standard development is to be carried out by the same group of experts that has already done the preparatory work and whose members work exclusively part-time for EFRAG. If EFRAG remains as the standard setter, adequate funding must be ensured and more time must be made available for the development of the standards.

The reporting standards to be developed should themselves follow the criteria of legal certainty, consistency, coherence, flexibility and simplicity. For this reason, it is essential that the reporting standards are based on internationally recognized frameworks, such as GRI and TCFD, and are integrated into the international reporting landscape (see also point 2 above). A working group of the Executive Boards of Deutsches Aktieninstitut and its French partner association AFEP is also committed to this.

7. Defer tagging

The added value of electronic tagging of the sustainability information to be reported in accordance with the new CSRD is not clear to us. Even in the case of electronic tagging of key financial figures, which has become mandatory as a result of the implementation of the EU Transparency Directive through the European Single Electronic Format (ESEF), it is highly doubtful whether the enormous additional effort for the companies (including additional legal risks) is offset by any benefit at all for investors. Moreover, there is no reliable IT infrastructure or machine language for tagging sustainability information, which, unlike financial indicators, has a narrative character.

Conclusion

With the new Corporate Sustainable Reporting Directive, the European legislator is taking sustainability reporting to a whole new level. The directive constitutes sustainability reporting obligations for companies that go far beyond the existing level of non-financial reporting. In order to ensure that the new requirements of the directive and the plethora of new legislation are designed in a targeted and practical manner, the corporate perspective must be taken into account comprehensively in the development of the standards. Only together with companies can a successful transformation process toward a climate-neutral economy succeed.

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