A&L Goodbody

ESG & SUSTAINABILITY

Sustainability reporting standards series

Part 4 – ESRS adopted by European Commission

On 31 July 2023, the European Commission (**Commission**) announced that it had adopted the first set of European Sustainability Reporting Standards (**ESRS**) for use by all in scope companies when preparing and presenting their sustainability statements so as to comply with the reporting obligations introduced by the Corporate Sustainability Reporting Directive (**CSRD**)[1]. The ESRS are set out in an annex to a draft delegated act. This draft will not enter into force until it is published in the Official Journal of the European Union. More information on the timeline to publication is set out below.

9 MIN READ

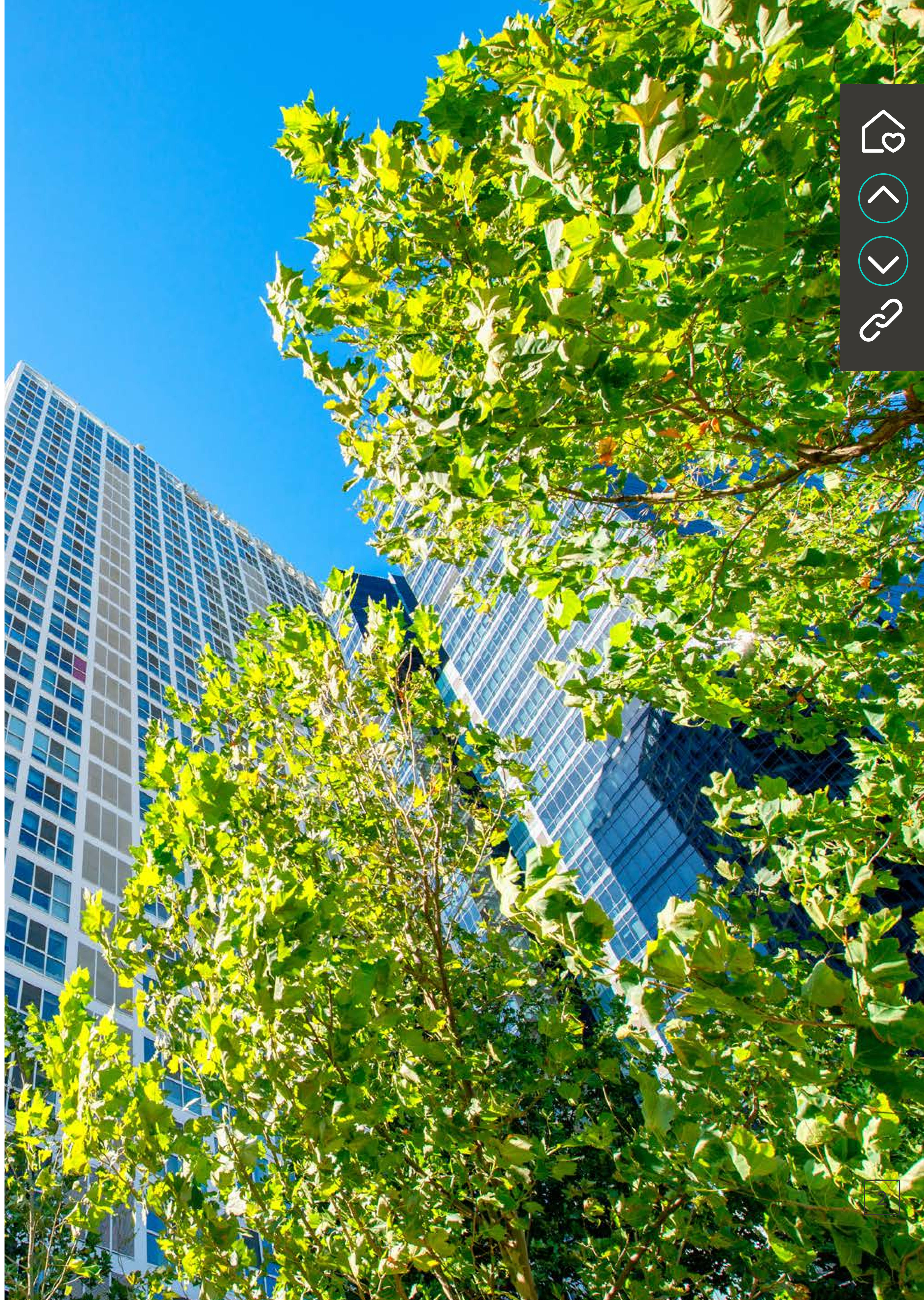
[1] *Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.*

In the previous instalments in this series, we considered the version of the ESRS published by the European Financial Reporting Advisory Group (**EFRAG**) in November 2022. The first instalment of our advisory series provided an overview of the draft ESRS. The architecture of the ESRS as described in this instalment remains unchanged and is highlighted again below. In the second instalment we focused on the first of the draft standards, ESRS 1, on the general requirements for reporting in line with the ESRS. In our third instalment, the focus was on the draft ESRS 2, which sets out 'General Disclosures' in respect of a reporting entity's sustainability statements.

This latest instalment of our Sustainability Reporting Standards Series takes a look at what has changed from the draft ESRS we considered previously. It also refers to the helpful document 'Questions and Answers on the Adoption of European Sustainability Reporting Standards' published on 31 July 2023 by the European Commission.

In this instalment, we review the architecture of the ESRS and then provide an overview of some of the key changes which have been made to EFRAG's draft of the ESRS.

Prior to adopting the ESRS, the Commission launched a public consultation on 9 June 2023 seeking feedback on amendments it proposed to make to the draft version of the ESRS published by EFRAG. The consultation period closed on 7 July with a number of respondents critical of certain amendments proposed by the Commission. We've highlighted some of key points on which the Commission has faced criticism below.



Architecture

By way of reminder, the first set of ESRS contains 12 separate standards (see Figure 1): 10 topical standards – meaning they relate to specific environmental, social or governance matters; and two cross-cutting standards – meaning they apply across all sustainability matters. Separate sector specific standards are currently being prepared although EFRAG is currently prioritising the publication of technical guidance relating to the first set of ESRS, meaning draft sector specific standards for key sectors are unlikely to be published for consultation until the fourth quarter of 2023, at the earliest.

Figure 1

<table>
<tr><th colspan="10">Cross-Cutting Standards</th></tr>
<tr><td colspan="4">**ESRS 1**
General Requirements</td><td colspan="6">**ESRS 2**
General disclosures</td></tr>
<tr><th colspan="10">Topical Standards</th></tr>
<tr><th colspan="10">Environment</th></tr>
<tr><td colspan="2">**ESRS E1**
Climate Change</td><td colspan="2">**ESRS E2**
Pollution</td><td colspan="2">**ESRS E3**
Water and marine resources</td><td colspan="2">**ESRS E4**
Biodiversity and ecosystems</td><td colspan="2">**ESRS E5**
Resource use and circular economy</td></tr>
<tr><th colspan="10">Social</th></tr>
<tr><td colspan="2">**ESRS S1**
Own workforce</td><td colspan="2">**ESRS S2**
Workers in the value chain</td><td colspan="3">**ESRS S3**
Affected communities</td><td colspan="3">**ESRS S4**
Consumers and end-users</td></tr>
<tr><th colspan="10">Governance</th></tr>
<tr><td colspan="10">**ESRS G1**
Business conduct</td></tr>
</table>

Four pillar approach

The ESRS framework takes a four pillar approach, as the Commission sought to align with the structure of international sustainability reporting frameworks including the Task force for Climate related Financial Disclosures (**TCFD**) recommendations and the International Sustainability Standards Board (**ISSB**) IFRS sustainability standards. EFRAG and the Commission also worked closely with the Global Reporting Initiative (**GRI**) to ensure alignment between the ESRS and the GRI's sustainability standards.

The four pillars are:

- governance
- strategy
- impact, risk and opportunity management
- metrics and targets

This four pillar approach essentially lays out the format that each of the standards follows in terms of structure and content. Generally the information sought under each of the four pillars is referred to as a disclosure requirement, each of which contains more granular data points or sub-elements of the particular requirement, referred to as a datapoint.

The Commission has confirmed that a significant amount of work has been done to ensure that the various sets of standards are aligned and that *"companies that are required to report in accordance with ESRS on climate change will to a very large extent report the same information as companies that will use the ISSB standard on climate-related disclosures."*

Changes to materiality assessment

Perhaps the most fundamental change to the ESRS relates to materiality assessment.

The vast majority of disclosure requirements, and individual datapoints within each topic, are now subject to a materiality assessment.

The exceptions to this rule are ESRS 1 on General Requirements (which does not impose disclosure requirements), ESRS 2 which provides for general disclosures on matters considered to be essential for companies to report on (including some reporting requirements on the company's own workforce and datapoints that correspond to information required by financial market participants and financial institutions for their own reporting purposes), and matters in respect of IRO-1 relating to topical standards.

Previously, the draft ESRS provided that a number of disclosures including, for example, elements of ESRS S1 relating to an undertaking's own workforce, were mandatory disclosure items for certain entities irrespective of their materiality to that entity, and would therefore have to be reported on.

Now reporting entities will only report information deemed to be material and may omit information that is not considered material to their business model and activity. This change was the subject of intense debate during the public consultation, but the Commission has confirmed its approach in this regard. The Commission has stressed in its Q&A, that "*disclosure requirements subject to materiality are not voluntary. The information must be disclosed if it is material, and the undertaking's materiality assessment process itself is subject to external assurance…*" in line with the independent assurance requirement for sustainability statements provided for by the CSRD.

As set out in our previous instalments, the ESRS require reporting entities to consider the principle of double materiality when making materiality assessments, in other words to report on both the impacts of their operations (which in time will include its value chain) on people and the environment as well as how social and environmental issues create financial risks and opportunities for the reporting entity. The ESRS includes a flowchart for determining the materiality of disclosures under ESRS at Appendix E to ESRS 1.

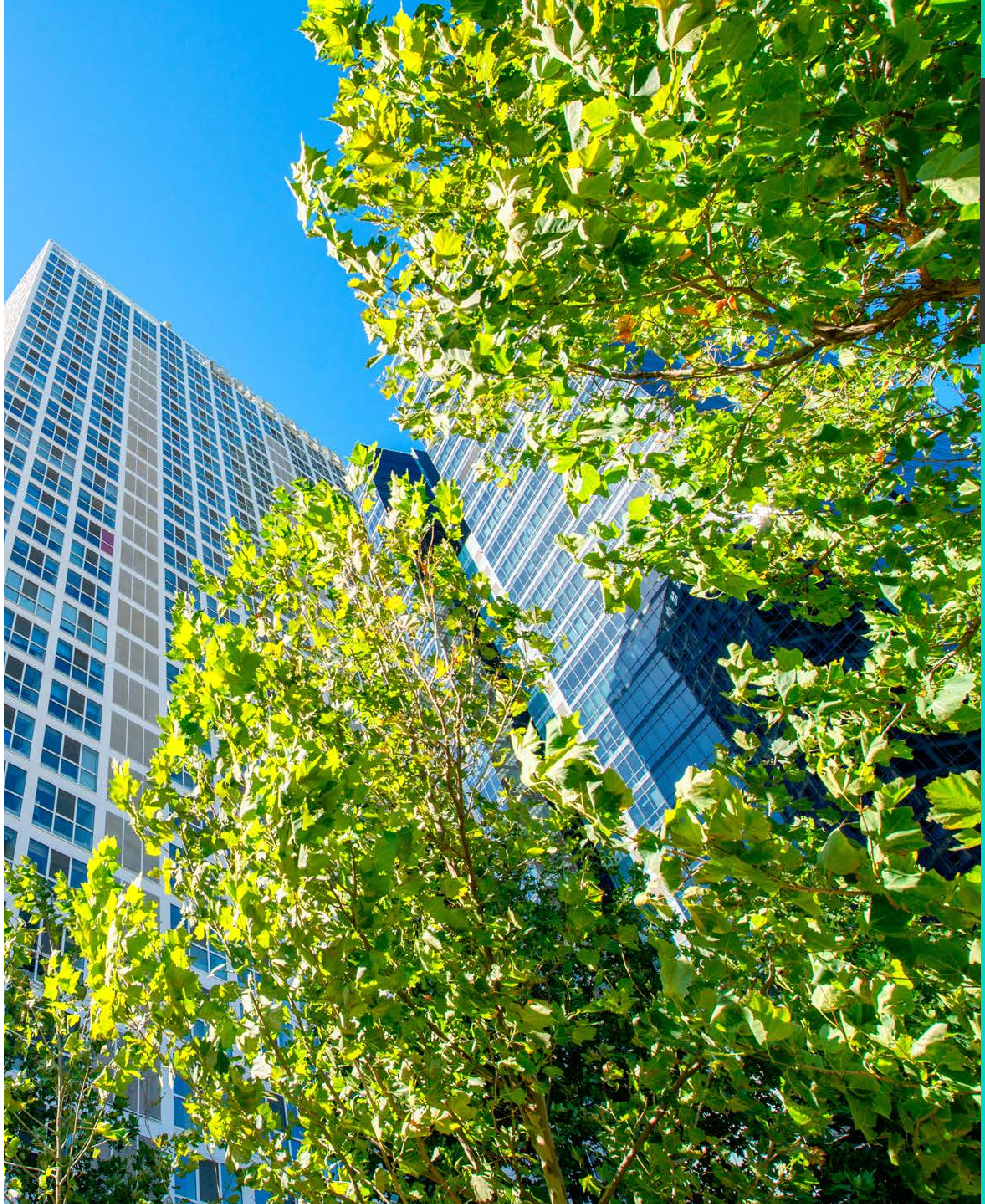
Materiality – key environmental disclosures

As may be inferred from the above section, disclosure under ESRS E1 – climate change, which in EFRAG's draft ESRS was mandatory for all reporting entities is now also subject to a materiality assessment. This aspect of the Commission's proposals proved particularly controversial during the public consultation period with some respondents arguing that to do so would *"lower EU ambition compared to global reporting standards"* and introduce a loophole for disclosure that might facilitate greenwashing.

In response to these criticisms, the final form ESRS has clarified that *"if an undertaking concludes that climate change is not material [to it] and therefore omits all disclosure requirements in ESRS E1 Climate change, it shall disclose a detailed explanation of the conclusions of its materiality assessment with regard to climate change … including a forward-looking analysis of the conditions that could lead the undertaking to conclude that climate change is material in the future."* (ESRS 1 section 3.2 – Material matters and materiality of information). This requirement reflects the Commission's view that *"climate change has wide-ranging and systemic impacts across the economy."*

Similar concerns were expressed regarding ESRS E4 on biodiversity and ecosystems, which it is acknowledged in the ESRS is a topic that is *"closely connected"* to climate change. Respondents argued that to make disclosures on this topic subject to materiality assessments would *"backtrack on the Commission's commitments to promote biodiversity transition plans in line with Target 15 of the Global Biodiversity Framework adopted at COP 15."* Regardless, a specific detailed explanation of the kind described above which has been adopted in relation to ESRS E1 is not required for entities that do not consider biodiversity and ecosystems material to their business and therefore won't report against ESRS E4.

A brief explanation can be included and as is the case with assessments of the materiality of other environmental, social and governance matters, a robust materiality assessment process, independently assured, is required of reporting entities to identity and assess material impacts, risks and opportunities. Underlying metrics are also required by the ESRS to be *"robust"* (ESRS E4-5 AR 27).



Phase-in of reporting requirements

Another key change introduced by the delegated act relates to the phase-in of reporting obligations. The application of phasing in is significantly amended from EFRAG's drafts amounting to a fundamental change. In recognition of the challenges that smaller entities may face in preparing sustainability reports, the ESRS now provide that entities with fewer than 750 employees during the financial year (on a consolidated basis, where applicable) may phase in a significant number of datapoints and omit them from their sustainability reports for certain periods, in addition to the phased in requirements contained in EFRAG's drafts regarding value chain metrics and certain indicators regarding non-employees.

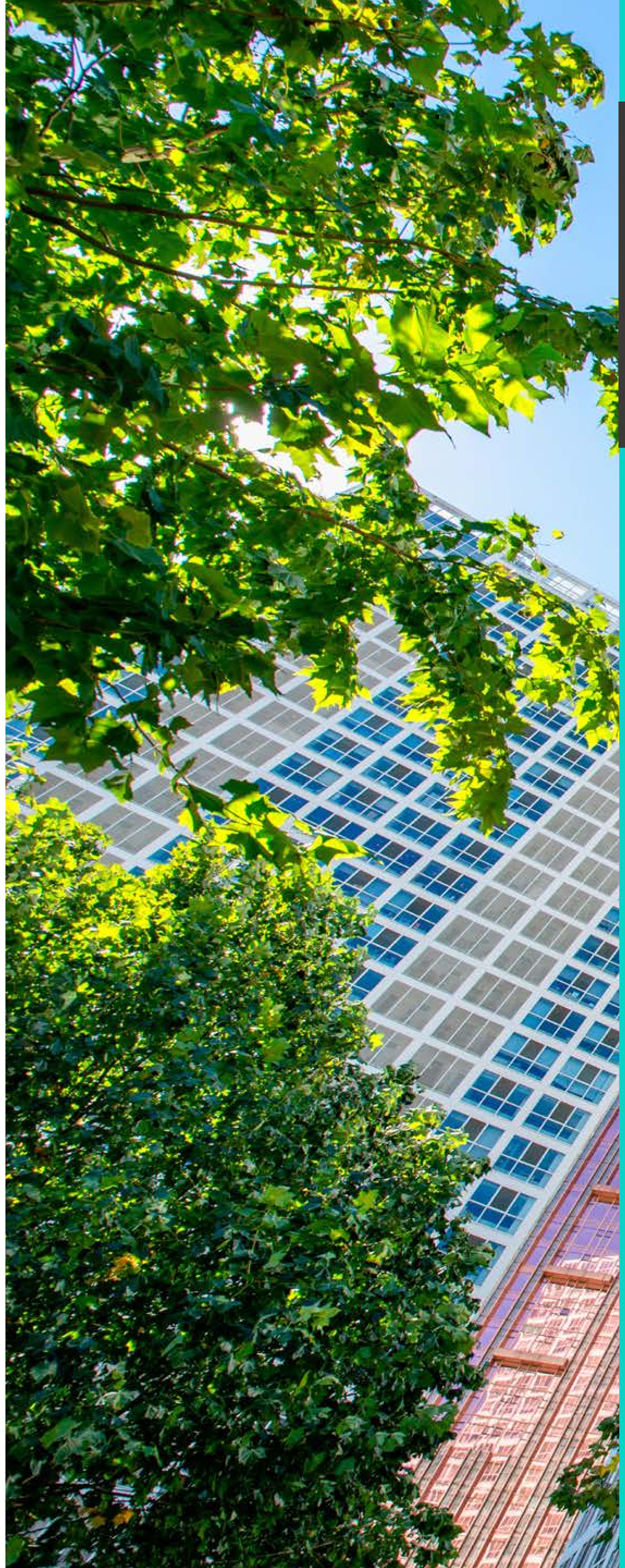
Where applicable entities choose to rely on these phased in requirements they may defer elements of their sustainability reporting for the first year of reporting (and in some instances year two and year three). The full list is set out in Appendix C to ESRS 1. See Figure 3 for a summary of the phased-in disclosure requirements.

Figure 3

Companies with fewer than 750 employees	All companies
1-year phase-in for scope 3 GHG emissions 1-year phase-in for own workforce standard (ESRS S1) 2-year phase-in for biodiversity (ESRS E4)value chain workers (ESRS S2) affected communities (ESRS S3) consumers & end-users (ESRS S4)	1 year phase-in for anticipated financial effects under pollution, water, biodiversity and resource use/ circular economy disclosure topics 1 year phase-in for certain social indicators - persons with disability, social protection coverage, family leave etc.

Commentators have suggested that the data relating to scope 3 emissions and total GHG emissions may have an adverse effect on financial market participants' ability to prepare disclosure required by applicable regimes including the Sustainable Finance Disclosure Regulation[2]. Where relevant entities avail of this phasing-in, the ESRS include requirements that undertakings must comply with certain minimum reporting standards.

[2] *Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance). Read more here.*

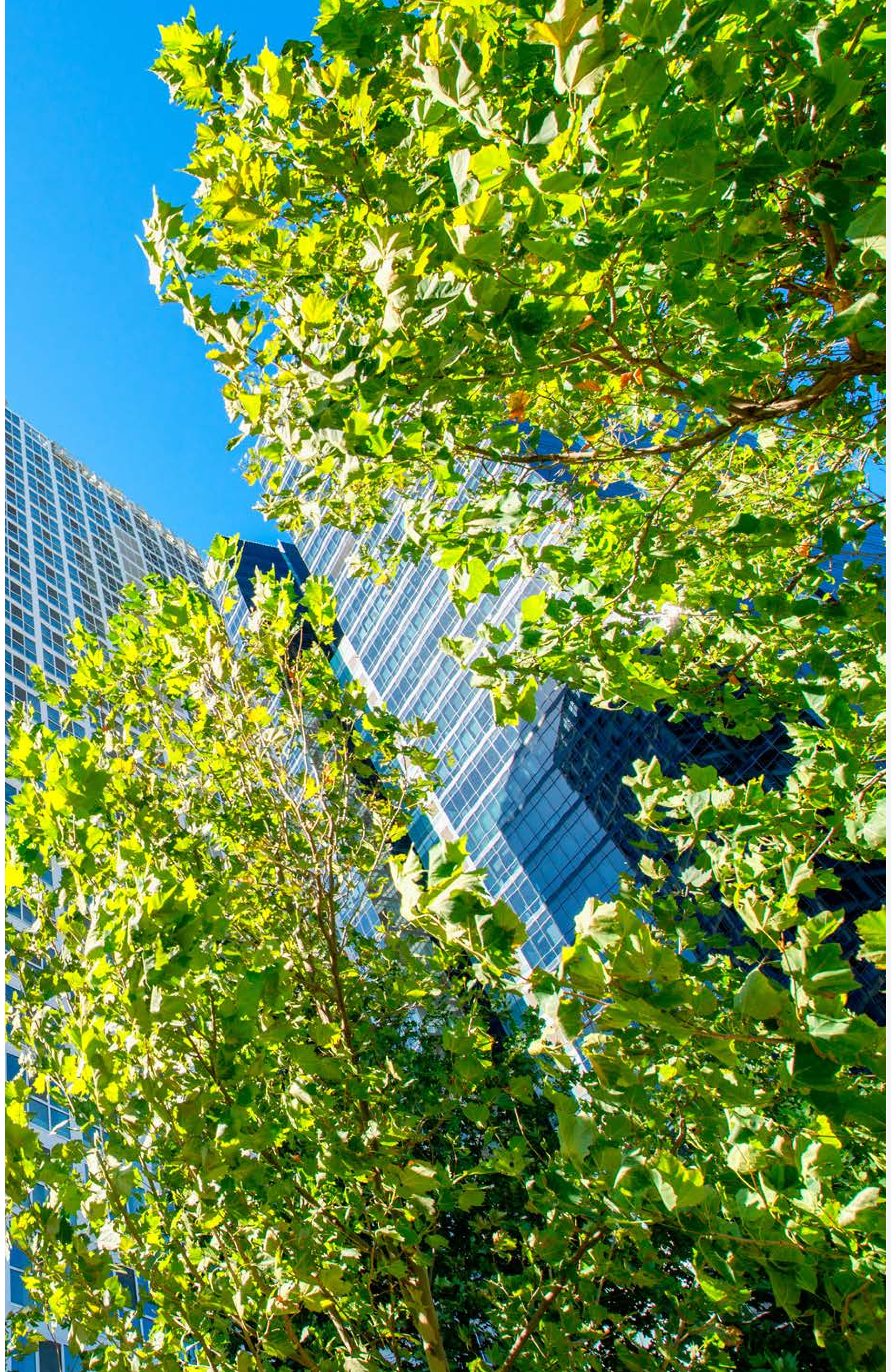


Next steps

The delegated act adopted by the Commission will be formally transmitted to the European Parliament and the Council in *"the second half of August"*. It will then be subject to a two month scrutiny period by Parliament and the Council, which can be extended by an additional two months. While it is possible for the European Parliament or the Council to reject the delegated act, they may not amend it. As such, we would recommend that:

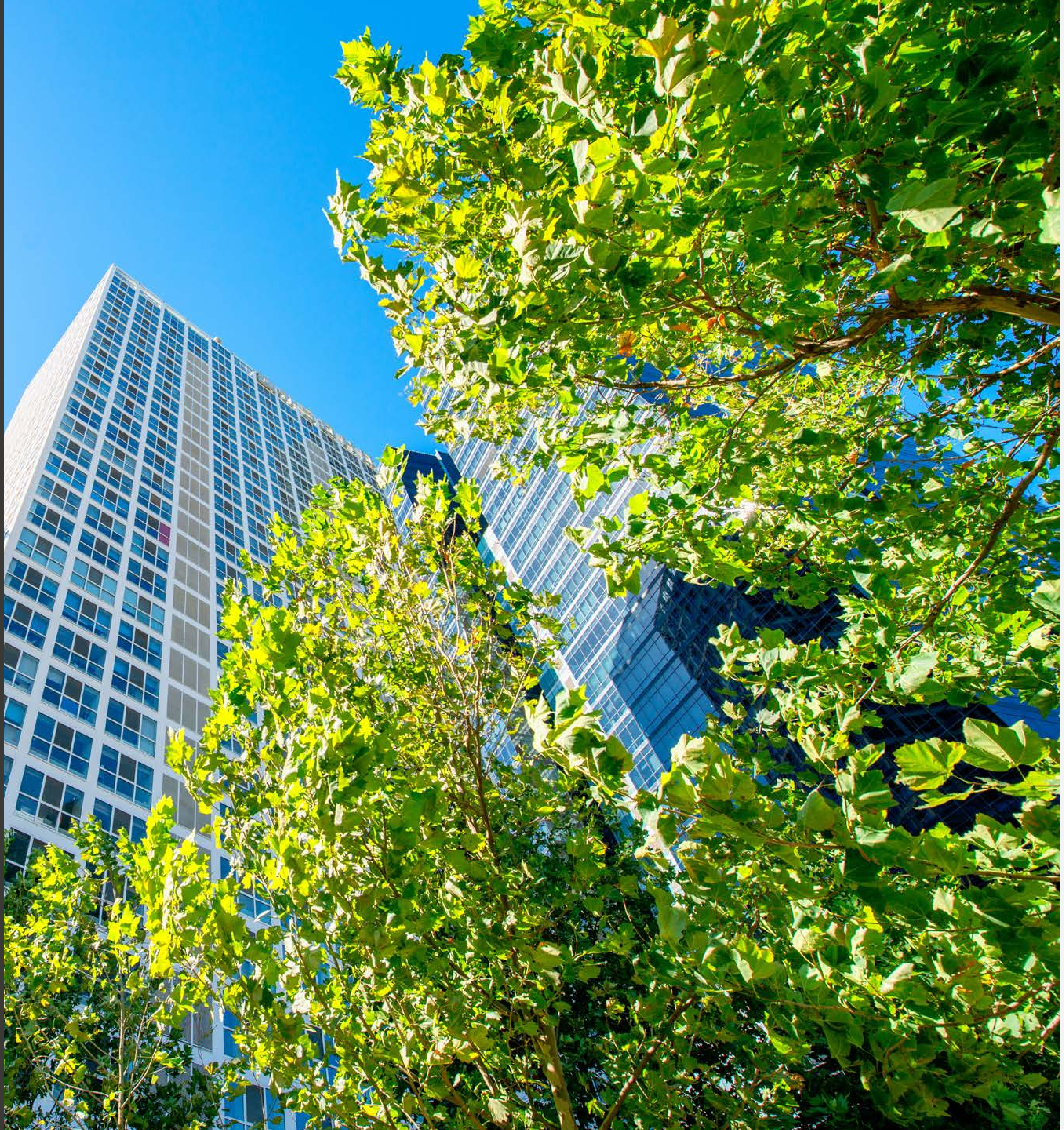
- companies assess whether they will be required to prepare sustainability statements
- in scope companies familiarise themselves with the content of the ESRS
- an assessment of the environmental, social and governance matters that are material to the company's business is undertaken

EFRAG has confirmed that it will periodically publish additional non-binding technical guidance on the application of the ESRS. The Commission has suggested that EFRAG prioritises the development of guidance on materiality assessment and on reporting with regard to value chains. EFRAG has stated that it expects to publish draft guidance on these two issues for public consultation *"in the near future"*.



Conclusion

The Commission's stated approach has been to ensure that *"the standards are proportionate, without undermining the achievement of the policy objectives"* of the legislator which will enable *"investors, civil society organisations, consumers and other stakeholders to evaluate the sustainability performance of companies, as part of the European Green Deal."* While there is no doubt that it will not only be reporting entities that will be affected by the introduction of sustainability standards, the standardisation of information and the ability to compare sustainability statements (and to assess the metrics and data used in compiling them) presents an invaluable opportunity for all stakeholders as the drive towards ever more sustainable business practices continues for businesses of all shapes and sizes.



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Resources

- CSRD — READ MORE
- Draft Delegated act — READ MORE
- Draft Delegated act - Annex 1 — READ MORE
- Draft Delegated act - Annex 2 — READ MORE