Comments to EFRAG on questions 8 to 12 (08.08.2022)

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EFRAG Sustainability Reporting Board Consultation Survey 1

EFRAG

EFRAG Sustainability Reporting Board Consultation Survey 1A

Consultation survey structure

1. Overall European Sustainability Reporting Standards (ESRS) Exposure Drafts' relevance (Survey 1)

- 1A. Architecture

Sustainability statements and the links with other parts of corporate reporting

For clarity and ease of use, standardised sustainability reporting shall be easily identifiable within the management report (MR). To that effect, ESRS 1 – General principles (paragraphs 145 to 152) prescribes how to organise the information required by ESRS. It offers three options (paragraphs 148 and 149) for undertakings to consider when preparing their sustainability reporting:

- a single separately identifiable section of the MR;
- four separately identifiable parts of the MR:

1. General information;
2. Environment;
3. Social;
4. Governance

- one separately identifiable part per ESRS in the MR.

The first option is the preferred option. When applying the other two options the entity shall report a location table to identify where disclosures are presented in the MR.
In order to foster linkage throughout the undertaking's corporate reporting, ESRS 1 also:

- prescribes that the undertaking adopts presentation practices that promote cohesiveness between its sustainability reporting and: (a) the information provided in the other parts of the management report, (b) its financial statements (FS), and (c) other sustainability-related regulated information (paragraphs 131 to 134)
- promotes the incorporation of information by reference to other parts of the corporate reporting in order to avoid redundancy (paragraphs 135 and 136)
- organises connectivity with the financial statements by prescribing how to include monetary amounts or other quantitative data points directly presented in the financial statements (paragraphs 137 to 143).

Q8: Do you agree with the proposed three options?

- ○ Yes
- ● No
- ○ No opinion

Q9: would you recommend any other option(s)?

If so, please describe the proposed alternative option(s)

Yes, we recommend a fourth option. As the linkage of sustainability disclosure requirements among each other (a) and to other parts of the financial statements (b) has´nt been sufficiently taken into account, the character of integrated reporting does not yet come into effect properly. Furthermore, we are concerned that the legibility of the management commentary will be impacted, if up to 137 additional sustainability disclosure requirements without filtering become part of the management commentary. Already the annual financial statements, including the management commentary, are often criticized as being too extensive. The huge amount of data could lead to an information overload for stakeholders and might hinder the desired ESG steering effect.

Therefore, the sustainability information should be clearly structured, measured, monetized and initially aggregated to a few performance indicators. We suggest that the classic and established performance indicators for pure financial reporting, such as net income, EBITDA or return on equity, are compared to the corresponding ESG-integrated performance indicators and published in the management commentary. The precondition is that sustainability information with its monetary values is recorded in a separate ESG accounting system. ESG accounting would then cover the financial materiality in the sustainability reporting, but without the matters already recorded in financial accounting. We call this concept "Sustainable Performance Accounting" (SPA). Differences in between classical and sustainability performance, e.g. net income and ESG-integrated net income, would become more apparent. The reasons for this difference are briefly to be explained in the three areas E, S and G, and, for more detailed information, referenced to the relevant passages of the disclosure requirements of the sustainability reporting and/or the notes to the financial statements.

Overall, the following five application steps result for SPA:
- SPA1: Determination of the ESG-issues.
- SPA2: Measurement of the ESG-issues.
- SPA3: Recording of the ESG-issues.
- SPA4: Determination of the integrated performance indicator(s).
- SPA5: Explanation of the differences of the performance indicator(s) from SPA4 subdivided into the E, S and G areas and reference to the specific locations in the financial statements and/or management commentary including the sustainability reporting, where further details on the ESG issues can be found.

Examples can effectively demonstrate the functioning of the SPA methodology, which is available here:

https://knuthenkel.de/ratgeber/sustainable-performance-accounting-spa/.
For further information, we are happy to provide EFRAG with our paper on SPA.

As some ESG issues are already part of classical financial statements, SPA would allow for better integrated reporting. In addition, SPA enables a drill-down presentation of the multitude of disclosure requirements for sustainability reporting. Based on the explanation of the differences between the non-integrated and integrated performance indicators, it is possible to selectively look up further details in the disclosure requirements of the sustainability reporting that are important to a stakeholder. In this way, an information overload of stakeholders can be avoided.

For applying SPA, the sustainability performance must be measurable. Certain ESRS standards provide for potential financial effects so that these can already be used as accounting information. However, there are not yet established valuation techniques for all ESG issues. We assume, however, that over time more and more valuation techniques for ESG matters will become established in practice. Our SPA paper contains a proposal for the valuation of ESG matters. Any accounting information that is added over time and can be integrated into SPA makes it easier to read the financial statements and the management commentary, including the sustainability reporting; and adds to the information quality according to ESRS E1.2.1 para. 25.

We are aware that many companies are busy with the (first-time) implementation of sustainability reporting and therefore do not have the capacity to set up ESG accounting. In our view, the latter should not be a major additional expenditure to the already existing financial accounting once the actual sustainability data has been determined and is available. So, we suggest the application of SPA as another (fourth) option for those companies that see the advantages of SPA and want to apply it. In a first step, applicants could be companies that want to eliminate the "P&L paradox of sustainable management" in classical financial reporting by applying SPA. This paradox arises from the time lag in the P&L between risk mitigation measure and the first time the risk becomes visible, which puts sustainable companies at a technical disadvantage in the P&L during the first few years.

Q10: in your opinion, to what extent do you believe that connectivity between the sustainability reporting and other parts of the management report has been appropriately addressed?

- ○ Not at all
- ● To a limited extent with strong reservations
- ○ To a large extent with some reservations
- ○ Fully
- ○ No opinion

Please explain your reservations or your suggestions for improvement or any other comment you might have

Please see our answer to Q9.

Q11: in your opinion, to what extent does the incorporation of information in the Sustainability section by reference to other parts of the management report support cohesiveness throughout corporate reporting?

- ○ Not at all
- ● To a limited extent with strong reservations

- To a large extent with some reservations
- Fully
- No opinion

Please explain your reservations or your suggestions for improvement or any other comment you might have

Please see our answer to Q9.

Q12: in your opinion, to what extent do the requirements and provisions on how to include monetary amounts and other financial statement-related quantitative data into sustainability reporting support connectivity with the financial statements?

- Not at all
- To a limited extent with strong reservations
- To a large extent with some reservations
- Fully (selected)
- No opinion

Please explain your reservations or your suggestions for improvement or any other comment you might have