EFRAG Input Paper – SFWG G 20 Brazilian Presidency

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1. THE LANDSCAPE IN SUSTAINABILITY REPORTING: MEDIUM AND LONG-TERM OBJECTIVES

1.1. ESG data availability: challenges and policy objectives

1 The global challenges linked to climate change and, more generally, to sustainable development have brought the need for a more sustainable economy to the top of the policy makers' agenda. The objectives of the Paris Agreement and the Sustainable Development Goals (SDGs) aim at a profound transformation of global economies, triggering sharp mobilisation of public initiatives and private investments. Notwithstanding progress, considerable challenges to the effective achievement of those policy objectives have been identified in recent years. In particular, the expected redirection of capital flows towards sustainable growth is not happening at the desired speed. Among the obstacles identified hampering the full achievement of the sustainable agenda is the lack of solid and comparable sustainability information and

performance indicators reported by companies. As illustrated by a recent OECD study[1], *the promulgation of different sustainability approaches, data inconsistencies, lack of comparability of ESG criteria and rating methodologies, as well as inadequate clarity over how ESG integration affects asset allocation*, hinder at global level the efficacy of ESG investing.

2 Similarly, in the European Union, it has emerged that to accompany the ambitious policy objectives and enable the sustainable transformation of the economy, the challenges connected to the availability and fragmentation of ESG data reported by companies, had to be addressed.

3 In 2021 these challenges were identified as follows[2]:

(a) Lack of ESG comparable and quality data: evidence shows that companies often omit information that investors and other stakeholders consider important. Reported information can be hard to compare from company to company, and users of the information, such as investors or other stakeholders, are often overwhelmed or are unsure whether it provides a faithful representation.

(b) Difficulties connected to uncoordinated ESG data requests: to fulfil the ESG data gap need stakeholders have developed uncoordinated frameworks that result in multiple data requests covering environmental, social and governance topics to elicit corporates data. This has led to fragmentation, low comparability and ultimately high administrative burden and high costs.

(c) Reliability of data: because of the lack of standardisation, with a multitude of different approaches and methodologies across sectors and type of companies, even within same jurisdictions, users face comparability concerns and question the quality and verifiability of the reported information.

4 At global level, several initiatives aimed at addressing the challenges related to data quality and availability are currently ongoing. New rules and frameworks in sustainability reporting are being established at international level and in the various jurisdictions worldwide with the objective to prompt reliable, comparable and high quality ESG information from companies.

[1] ESG Investing and Climate Transition, Market Practices, Issues and Policy Considerations OECD, 2021
[2] Commission staff working document executive summary of the impact assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting

Without consistent and relevant data, it is difficult to make informed policy or investment decisions and drive change.

5 In establishing and streamlining existing sustainability reporting frameworks standard setters and policy makers face important methodological questions.

(a) The first one is to determine the scope of the reporting. Which entities shall be in the scope of sustainability reporting obligations? Shall the focus be on the publicly listed companies that traditionally have to abide mandatory financial and non-financial disclosure requirements issued by regulators and stock exchanges? Or should the focus be on a broader group of companies in line with stakeholders, civil society and investors' call for greater transparency on sustainability risks and performance, independently of the company statute? In terms of size of reporting companies: should the reporting obligations be limited to the large ones or also include the smaller and medium sized companies or include them only if listed on stock exchanges?

(b) Another important element is the range of sustainability matters to be covered. Should the disclosure regimes focus on environment or climate only, prioritising for instance the urgency of the Paris Agreement commitments? Or should disclosures encompass the broader sphere of the environmental, social and governance matters (ESG) to ensure that the three dimensions move at the same pace? Would one or the other approach facilitate or rather undermine the broad uptake of reporting?

(c) Another key question is related to the materiality regime and users of the sustainability reports. Should the reporting companies follow the well-established financial accounting materiality concept, or should this concept be adjusted to include a double materiality approach? While traditional financial materiality perspective would look at how sustainability topics influence enterprise value with main audiences being investors, lenders or other creditors, double materiality also includes impact materiality, that would look at how sustainability topics impact people and the planet, and then translate into financial risks and opportunities, with the additional audiences for impacts being governments, consumers, business partners, employees, civil society organisations and local communities at large.

(d) Next to materiality, the mandatory aspect of the disclosures is also to be considered. Should the disclosures be required mandatorily and always to be reported or should

there be a voluntary approach? Could the mandatory versus voluntary regimes be modulated according to type of disclosures or type and size of reporting companies?

(e) Finally, the issue of mandatory assurance versus non-mandatory and the digital versus human-readable ESG reporting question may also be important elements to consider. How would those elements affect data quality, reliability and usability? Would this broaden availability of ESG information for a wider range of stakeholders?

6 In a nutshell, while the non-exhaustive list of considerations above may provide common questions that are emerging in the sustainability standard setting sphere at global level, answers may take different shapes and trigger different reflections depending on each jurisdiction' intended direction of travel and the willingness to foster international consistency inspired by initiatives such as the ones developed by the IFRS Foundation and GRI.

1.2. Focus on the EU approach: The EU Corporate Sustainability Reporting Directive (CSRD)

7 The European Union offers a practical example of how the combination of ambitious policy objectives and challenges related to lack of sustainability information by companies have been addressed via the establishment of a new sustainability reporting regime.

8 The European Union has set ambitious sustainability policy objectives in recent years with the European Green Deal, the new climate law and the sustainable finance package to redirect the necessary capital and financing flows towards sustainable investments. To accompany the effective achievement of those policy objectives both the European Parliament and Council called for further action in sustainability reporting. The European Council in its Declaration of December 2019 stressed the "importance of reliable, comparable and relevant information on sustainability risks, opportunities and impacts to deepen the capital market union"[i].

9 Consequently, the new Corporate Sustainability Responsibility Directive (CSRD) was adopted in June 2022. This new legislation brings important innovations by introducing a mandatory regime of sustainability reporting for large entities (250+ employees) and listed small and medium sized companies (excluding micro). This framework has the purpose of helping investors, civil society organisations, consumers and other stakeholders to evaluate the sustainability performance of companies, as part of the European Green Deal. The directive also clarifies and strengthens the key concept of double materiality (impacts and financial risks/opportunities). It establishes that the location and timing of reporting is in a separate section of the management report, which means is published at the same time as financial statements. In addition, the directive introduces an assurance regime starting with a requirement for limited assurance. This has important consequences in terms of fostering the

availability of high quality data and ensure comparability. The usability of ESG data is further enhanced by the digitisation of the sustainability reports that is also required by the CSRD under the European Single Access Point (ESAP) where all reported data will be stored and made publicly available.

10 Under the directive, reporting will be progressively phased in:

(a) 2024 as the reporting year for previous Non-Financial Reporting Directive (NFRD) reporters;

(b) 2025 as the reporting year for the other large entities;

(c) 2026 as reporting year for listed small and medium businesses, small non-complex banks and captive (re)insurances (with opt-out option for listed small and medium businesses until 2028);

(d) 2028 as reporting year for non-EU companies with branches/subsidiaries in the European Union. More specifically, these are non-EU companies generating at least €150 million net turnover in the European Union and with at least one branch generating at least €40 million net turnover in the European Union or one subsidiary in the European Union that is itself a large entity or a listed small or medium-sized business).

11 The sustainability reporting requirements of the CSRD only apply to SMEs with securities listed on EU regulated markets. In practice this means that the overwhelming majority of SMEs are not subject to sustainability reporting requirements.

12 The directive mandates the use of European Sustainability Reporting Standards (ESRS) developed by EFRAG and adopted by the European Commission (through delegated acts). These standards have a comprehensive coverage of ESG (environmental, social and governance) sustainability matters. They provide a robust framework to elicit more consistent and reliable ESG data and thereby support overall the sustainable transition.

13 A first set of ESRS was issued by EFRAG in November 2022 and adopted as a delegated act by the European Commission (EC) in July 2023. Important to note that in the pathway that led from the release of the first EFRAG proposal for ESRS in April 2022 to the final EFRAG technical advice in November 2022 and finally to the adoption by the EC delegated acts in July 2023, extensive public consultations took place and, taking into account feedback received, simplifications have been introduced. These simplifications include: i) phasing-in certain reporting requirements; ii) giving companies more flexibility to determine what information is relevant ("material") in their

circumstances; and iii) making some of the proposed requirements voluntary. The ESRS are expected to help companies to reduce reporting costs in the medium and long term, by avoiding the use of multiple voluntary standards as is the case today.

14 The key elements for the European Sustainability Reporting Standards are:

(a) a total of 12 standards that cover cross-cutting general requirements and disclosures, which apply to all sustainability matters, and 10 topical standards (5 environmental, 4 social and 1 governance) that embed 84 qualitative or quantitative disclosure requirements.

(b) double materiality (impact and financial): sustainability statements shall reflect all material impacts, risks and opportunities under an objective approach based upon relevant thresholds. The reporting entity must implement a rigorous materiality assessment process to determine its material impact, risks and opportunities to be reported upon.

(c) they are based on a hot spot approach: ESRS do not require companies to report all information about their value chains. Rather, they follow a "hot spot approach", meaning that companies would only need to report information when there are material risks or impacts related to the value chain.

(d) they cover four pillars: i) governance, ii) strategy, iii) impact, risk and opportunity management, and iv) metrics and targets.

(e) they have high level of interoperability and alignment with the standards developed by the International Sustainability Standards Board (ISSB) and Global Reporting Initiative (GRI).

(f) in addition, a digital tagging is made available for translation of reporting into digital format.

15 The features of the CSRD and ESRS described above provide a concrete illustration of the policy choices and standard-setting approach adopted in Europe.

2. A ROBUST AND PROPORTIONATE SET OF SUSTAINABILITY STANDARDS AS A WAY FORWARD

2.1. Standardisation as a path to burden reduction and societal benefit

16 One of the main challenges identified in the sphere of corporate sustainability reporting has been the proliferation of multiple uncoordinated initiatives. A recent analysis has identified more than 300 mandatory reporting schemes and more than 200 voluntary reporting schemes

in 60 countries[3]. In this context preparers face difficulty and complexity when deciding what information to report because those frameworks may be inconsistent or may be overlapping or covering partly similar sustainability topics. This creates significant burden for preparers. It demonstrates a critical need for consolidation and comparability and interoperability.

17 Furthermore, preparers face the difficulty of accessing the sustainability information of their business counterpart (suppliers, clients and investee companies) that often do not report or not adequately report their ESG performance. This increases the effort required from preparers in compiling their own sustainability reports. In general, this leads to preparers incurring unnecessary costs and burden associated with the reporting of sustainability information.

18 Hence standardisation of frameworks at European and international level represents an important potential to reduce unnecessary administrative costs in particular by bringing greater clarity and certainty about sustainability data and the methodologies behind sustainability disclosures. Moreover, this facilitates availability of sustainability data for preparers, data that for reporting or management purposes they need to receive from their business partners (suppliers, clients and investee companies). In addition, a standardised approach has the benefit of reducing the burden of additional scattered sustainability information demands.

19 This objective has widely been pursued by the ESRS in Europe as illustrated by EFRAG in the explanatory note[4] that accompanied the release of the technical advice for the draft ESRS. ESRS provide comprehensive standards that consolidate and streamline a wide range of existing sustainability frameworks and private initiatives from GRI (Global Reporting Initiative) to TCFD (Taskforce for Climate related Financial Disclosure), from TNFD (Taskforce for Nature related Financial Disclosure) to UN sustainable development goals to ISO (International Organisation for Standardisation) standards). They incorporate the key concepts of the UN Guiding Principles and the OECD Guidelines for Multinational Enterprises, next to principles based on international conventions, e.g., ILO Conventions. ESRS also consistently embed existing regulations within the EU, such as the Sustainable Finance Disclosure Regulation (SFDR), the EU climate transition Benchmark Regulation (BR) and the EU Taxonomy Regulation (TR). In doing so they provide a robust and comprehensive single set of standards that systematises existing scattered initiatives. This has an important potential in terms of cost savings and burden reduction for the reporting companies and for entities in their value chains, with overall efficiency gain and societal benefits.

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[3] Effects Analysis IFRS®, Sustainability Disclosure Standards, IFRS Sustainability, June 2023

[4] EFRAG Explanatory note on how draft ESRS take account of the initiatives and legislation listed in Article 1 (8) of CSRD adding article 29b in the Accounting Directive 2013/34/EU, EFRAG November 2023.

20 Furthermore, the EU sustainability reporting standards play a pivotal role in the enhancement of transparency and increased availability of robust and comparable ESG information. The fact that companies disclose in a standardized manner their environmental, social and governance impacts, risks and opportunities allows investors to make informed decisions and to direct their investments towards long-term economic growth. This has broad societal and policy benefits. Additionally, *the greater availability of sustainability information allows citizens, trade unions, NGOs, and other societal organisations to hold undertakings accountable for their societal and environmental impacts. The proper implementation of the ESRS is likely to ultimately contribute to a reduction in the systemic risks to the economy, increased capital flows to undertakings addressing sustainability issues and a strengthening of the social contract between undertakings and citizens*[5].

2.2. Involvement of all players and proportionality: standardisation and SMEs

21 While definitions of small and medium sized businesses (SMEs) change across the globe, there is a common underlying feature in worldwide economies on the key role played by SMEs. Recent research by the United Nations Environmental Programme indicates that "*globally, it is estimated that formal SMEs account for 52 per cent of private sector value added; if the informal sector is included, this figure is significantly higher. SMEs provide between 58 per cent of employment in North America to 88 per cent in South East Asia. Clearly, sustainability reporting can make a significant contribution to improving sustainability at a global level, but to have a significant impact, it needs also to penetrate the SME sector*[6].

22 A recent study covering more than 16,000 enterprises worldwide[7], has found that requests to SMEs for sustainability-related data are rising in frequency and complexity. This is frequently referred to as the "trickle-down effect", where such requests come from larger companies that need sustainability information about their value chains. However, the lack of time, expertise and resources means that many SMEs are not able to measure and track their sustainability performance appropriately.

[5] Cost-benefit analysis of the First Set of draft European Sustainability Reporting Standards, CEPS, November 2023.

[6] Enhancing the uptake and impact of corporate sustainability reporting, UNEP, 2019

[7] Path for Growth: Bridging the SME Sustainability Reporting Gap, Sage, ICC, PwC UK, and Strand Partners, November 2023

23 In this context several national and international private led initiatives have in recent years developed tools and guidance aimed at supporting SMEs. As SMEs are often suppliers for larger companies which are progressively requiring their suppliers data on their sustainability criteria, they are increasingly involved in supply chain management and are incentivised to report.

24 However, as discussed in the previous section, the coexistence and dissemination of private frameworks that are fragmented and not coordinated can result in increased complexity, costs and burden for SMEs, in particular as smaller companies are in general less resourced than the larger ones.

25 To address those challenges, in Europe, where micro, small and medium sized companies represent 99% (in number) of all businesses, beside the ESRS for large undertakings, EFRAG has also launched two workstreams for simplified sustainability reporting standards for SMEs and is currently publicly consulting on its two Exposure Drafts (EDs). The aim is to create a system of European sustainability reporting standards that is inclusive, allowing all companies from the smallest to the largest to participate in and contribute to the sustainable transition.

26 EFRAG workstreams on SMEs intend to achieve sustainability reporting standards that are proportionate and relevant to the capacities and the characteristics of small and medium-sized undertakings and to the scale and complexity of their activities. While proportionality is the focus, consistency of concepts and principles with the ESRS for large undertakings is a fundamental component to achieve a system of standards that is compatible and can effectively reduce the risks of uncoordinated information requests to SMEs in value chains.

27 The overview of the two EFRAG SMEs workstreams and the related objectives and scope is as follows:

(a) The standard for small and medium sized undertakings with securities listed in EU regulated markets (ESRS LSME) is legally binding according to CSRD and focuses on public accountability and investors' needs perspective. ESRS LSME is expected to increase the availability of sustainability information provided by listed SMEs to financial market participants and in this way ensure a level playing field between smaller and larger issuers; hence enhancing access for smaller listed companies to sustainable financial capital and investment portfolios. This standard also applies to small non-complex credit institutions and captive insurance and re-insurance undertakings.

(b) The voluntary standard for non-listed micro, small and medium sized undertakings (VSME) is a simpler tool that aims at facilitating SMEs participation in the transition to

a sustainable economy and to respond to requests for sustainability information in an efficient and proportionate manner. Those data requests stem from their business partners that need ESG data, either for ESRS reporting obligations (trickle-down effect), or for sustainability management purposes (in investment portfolios or in the supply chain) or to substantiate their sustainability commitments (i.e. net-zero pledges, principles for responsible banking, etcetera). Non-listed SMEs (including micro) represent the vast majority of companies in Europe amounting to about 22 million in total. VSME represents for them an opportunity to start, in a proportionate manner, monitoring their ESG performance and better access business opportunities resulting from the transition, including access to green finance.

28 As a voluntary tool, a fundamental aspect of VSME is its market acceptance: (a) On the preparers side, SMEs accepting the standard as a simple reporting tool that is aligned to their capabilities and needs to monitor their sustainability performance while also responding to growing requests of sustainability data from business partners; and (b) on the user side, acceptance by business partners, i.e. lenders, investors, and corporate clients, to replace their multiple questionnaires and use instead the VSME to gather sustainability data from their SMEs clients or suppliers. Hence VSME should set a practical benchmark in the market for the level of information that it is reasonable to expect SMEs to provide. From this angle, important questions in the ongoing public consultation also aim at delving into the real need and purpose of data requests: are those data points a "must have" or "nice to have" from the business counterparts' perspectives? This is particularly relevant as VSME aims at fulfilling a market need and does not depend on legal provisions.

29 A recent OECD study[8] has highlighted that financial institutions already seek sustainability-related data from SME clients either directly or via ESG data or rating providers. Furthermore, there is no common approach among financial institutions to the type of data and information they seek from SME clients. *In this context, SMEs face a multitude of data requirements, which increases their reporting burden and acts as an additional barrier to finance. This is notwithstanding the fact that many SMEs, particularly micro-firms, may already be operating at net-zero, but may not be able to report on their performance*.

30 In this context EFRAG work on SMEs strongly draws upon interactions and dialogue with SMEs organisations or small practitioners on one side and financial institutions and large corporates, heads of supply chains on the other side. In addition to this engagement process, EFRAG has

[8] Financing SMEs for sustainability –Financial institution strategies and approaches, OECD, 2023

also taken an evidence-based approach analysing current national or international initiatives addressing banks or large companies/ supply chain data requests to SMEs.

31 To support SMEs in this process EFRAG is organising outreach events and workshops. It has made available written Q&A and educational material such as explanatory videos on the two SME standards and ad-hoc sessions and webinars; through the involvement of national standard setters, translated versions of VSME and national workshops in the various EU languages are being organised. This is to multiply and ensure engagement of all relevant stakeholders in the standard-setting process.

3. STANDARD SETTING TECHNIQUES TO INTRODUCE PROPORTIONALITY FOR SMALLER ENTITIES

3.1. General considerations in the approach to simplification

32 The standards for SMEs require a methodology that allows to achieve key simplifications and proportionality in line with the reduced complexity and capabilities of smaller or less resourced entities while ensuring certain core ESG data is provided. In this respect, it is suggested that the same simplification techniques may be equally valid, possibly as a first step, and may be explored for companies that are less resourced independently of their size (i.e., large companies in lower income countries).

33 In general, there are a number of trade-offs that may be considered when designing reporting frameworks adapted to less resourced entities. For example, an important question that may emerge in the standard setting process is what starting point to take. Is it more appropriate to start from the sustainability reporting standards designed under more comprehensive regimes and apply ad-hoc or surgical simplifications? Or to enact a complete redesign? The final decision may be connected to the type and size of companies in scope. For example, for micro entities a bottom-up approach, building on their needs and capabilities, including accessible language and limited number of disclosures, may be more appropriate. While for small and medium sized listed entities it may be more appropriate to adopt a top-down approach, starting from the larger companies reporting framework and applying simplifications in order to fit their capabilities.

34 The materiality regime is also a key parameter. Is materiality a help or a burden for smaller and less resourced entities? While for larger undertakings and listed SMEs the assumption, could be that the materiality analysis is a simplification since it allows to filter and focus disclosures via a hot spot approach, this assumption appears less obvious for non-listed smaller or micro-

entities. This is due to the fact that larger companies and to a certain extent smaller or medium sized companies that are listed in a regulated market, are exposed to a higher degree of oversight and public accountability that implies also a familiarity with reporting obligations imposed either by legislation or by stock exchanges. In line with the assumption of a higher degree of sophistication, the materiality assessment can be a helpful tool for them to focus the reporting on relevant matters and it can further be a strategic and business management tool. In the design of simplified standards and in particular the ones targeting micro and small non-listed SMEs this may be less obvious and other approaches can be more effective. Stakeholders often argue that a closed list of disclosures may be more fit-for-purpose for less resourced entities, therefore establishing a reporting regime based upon compliance rather than fair presentation. This is on the assumption that a check list does not imply any judgement or conceptual framework that would be too demanding for smaller entities. The standard setting approach may consider in this case different alternatives: for example, a guidance to SMEs on what triggers the reporting and how to define circumstances that determine the relevance of an information, such as conditionality or applicability concepts. Or it may consider a very short list of mandatory disclosures: very few selected disclosures to be reported by all SMEs in all circumstances. Or it may consider simplifications to the materiality analysis that may substantiate a step-by-step guidance or partial check-list approach to material sustainability matters.

35 Another important question that may emerge in the standard setting process for SMEs is the approach to value chain. Is this needed for smaller and medium sized entities and if yes why? There may be arguments in favour of dropping entirely value chain related disclosures for SMEs, since those entities may have shorter value chains that may result in a lower possibility of impact, both upstream and downstream. However, such an approach may depart from the fair representation principle and may limit the consistency of approaches in sustainability reporting as well as the “hot spot” thinking or even undermine the aggregability of sustainability information. Another aspect is whether “potential impacts” for example could be dropped in a simplification exercise asking to SMEs to limit their disclosures to actual impacts only. While there may be clear merits in terms of simplifying concepts, such an approach may come at the price of impairing consistency in reporting. Creating discrepancies between larger and smaller entities may result in hampering the usability of ESG information. For example, reducing the capacity to aggregate data from a business partner perspective in particular when for business partners (larger companies, banks or investors) the full definition of impact materiality would apply.

36 An additional trade-off may concern the alignment with international baseline standards. While interoperability across jurisdiction is a priority for sustainability reporting standards for large entities, to what extent is this an element to prioritise for SMEs? In this case while international alignment may remain an important component of the design of a simplified standard, simplification and alignment are to be considered under a balanced approach..

3.2. Concrete simplifications applied in the EU in current Exposure Drafts for SMEs

37 EFRAG work on the two workstreams on SMEs, described in section 2, provide a concrete case on how some of the standard setting questions on simplifications have been considered. The outcome of this work has led to the publication of the two exposure drafts for SME, the ESRS LSME ED and VSME ED that together achieve several simplifications to substantiate the proportionality principle, as follows:

(a) **ESRS LSME ED**

(i) Reasonable effort: In order to be more flexible and proportionate, compared to ESRS for large undertakings, the concept of 'reasonable effort' has been more widely used as compared to 'every reasonable effort', used for large undertakings. Moreover the concept of 'without undue cost and effort" has been introduced in the disclosures concerning direct value chain data collection and financial effects as additional simplification.

(ii) Voluntary disclosures for opportunities and positive impacts and other optional disclosures have been included as voluntary content, with the CSRD requiring a focus on risks and negative impacts. However, as users may be interested in information about opportunities and positive impacts, SMEs who pursue them may be incentivised to report. Hence significant elements of a voluntary regime have been included in the draft LSME. This allows to simplify as it reduces mandatory content.

(iii) Grouping of narrative disclosures on policies, actions and targets to cover all sustainability matters across E, S and G under one disclosure only. The grouping of the narrative components was included to increase usability of the standard and has been a significant part of the simplification in the methodological approach compared to the ESRS for large undertakings for which the disclosures on policies, actions and targets are located under each of the topical standards, implying

detailed and separate disclosure for environment, social or governance. The reason for the centralisation is that smaller undertakings have mostly policies, actions and targets across environmental, social and governance in line with their lower level of complexity that usually does not pursue specific separate policies, actions or targets for each of the sustainability matter, as it is more often the case for larger undertakings.

(iv) Topical disclosures include metrics only: to simplify the overall architecture and increase usability of the standard, another methodological choice has been to keep in the topical sections for E, S and G only metric disclosures. Moreover, to achieve the right balance between users' needs (granularity of the topical disclosures) and costs for SMEs under a proportionality approach, the decision was to highlight the key role for the materiality of information. In fact, the final granularity of the reported disclosure crucially depends on the conclusion of the undertaking's assessment of materiality of information. A specific provision was included in each topical section to promote a balanced approach when exercising judgement on the materiality of information.

(v) 'Report if you have' component: for certain disclosures, such as targets or due diligence, SMEs are required to report only if they have those elements in place already. If not, no report is required, and no explanation is needed. This simplifies and reduces the number of disclosure and allows focused reporting. It also constitutes an additional simplification compared to the regime for large undertakings who have to report in a statement that they do not have policies, actions and targets for material matters or that they do not have due diligence processes in place. For SMEs the omission does not require a statement nor an explanation.

(vi) Reduced granularity and number of disclosure requirements as compared to the ESRS for large undertakings: from the aggregation of all simplifications introduced in ESRS LSME, EFRAGestimates 47% reduction in the draft LSME as compared to ESRS for large undertakings. The reduction includes "shall" datapoints, "report if you have" and "if applicable" components.

(b) **VSME ED**

(i) Modular approach: VSME ED is composed of 3 modules: i) the basic module (entry level, ii) the narrative- PAT (Policies, Actions and Targets)- module and iii) the

business partner module. The modularity allows to combine the needs and complexities of very different companies from the ones below 10 employees up to the ones with 249 employees. Each module also helps satisfying clearly defined purposes.

(ii) Flexibility is overarching the full standard. On the one hand by providing flexible use of the modules that can be combined according to the decisions of the reporting SME, who may choose to only use the basic or to combine it with one or both of the other modules. On the other hand, the SME can also choose to complement its basic module disclosure with additional disclosures from the other two modules (without implementing them in full) or with additional disclosures specific to its sector of activities.

(iii) No materiality analysis in basic module: disclosures in the basic module are to be reported and preparers do not need to complete a materiality analysis. This important simplification was introduced following feedback received during the standard-setting process. The reason is that the performance of a materiality analysis was considered to be too complex for micro undertakings given the judgement and sophistication required in contrast with their average complexity and capabilities. As the basic module's target audience is micro-undertakings, materiality was replaced with "applicability". This is to guide micro and other SMEs in assessing and filtering whether the disclosure requirement applies to their circumstances or not.

(iv) Limited number of disclosures: both the number and granularity of disclosures have been considered very carefully. As such each of the three modules entails a very limited number of disclosure (12 in the basic module, 5 in the narrative and 11 in the business partner). In the basic module all disclosures are metrics only (except for one), this was also part of the simplification choice.

(v) Language simplification: it is a key component of the VSME ED where concepts and disclosures are expressed in as simple a terminology as possible while maintaining consistency with the rest of the ESRS literature. The reason to simplify the language emerged in the standard setting process as a way to lower the barrier and increase the understandability of the standard especially for the smallest companies. Where needed simpler terms were bridged via the glossary with the

terms used for ESRS for large undertakings to prevent impairing the overall consistency.

(vi) Guidance for applying VSME: the guidance is also based on maximum language simplification. It provides explanations of concepts and calculations referring for examples to water or electricity bills to practically overcome what could be perceived as difficulties for the reporting. The Guidance also shows table and presentation of information. It illustrates where needed available material already existing for SMEs.

38 The simplifications implemented in the ESRS LSME and VSME EDs are being tested in the current public consultation that will validate to what extent the proportionate standards for SMEs correspond to stakeholders' expectations.

3.3 Final consideration on trickledown effect related to SMEs

39 The illustration of standard setting work for smaller entities has highlighted how, despite the fact that the vast majority of SMEs are not subject to regulatory reporting requirements, they may receive requests for ESG information from their business counterparts (i.e., banks, investors or head of supply chains) as part of the so-called trickle-down effect.

40 As described in previous paragraphs the requests for ESG information addressed to SMEs that are clients of banks or suppliers of large companies, may be needed to steer portfolios towards more sustainable path, or for risk management or ESG supply management purposes. They may be connected to public commitments such as Net-Zero pledges or to achieve objectives set in sustainability strategies. In some cases, the ESG data requests are addressed by the larger entities to the smaller ones in their value chains also for their own sustainability reporting purposes. This flow of sustainability information accompanies the shift to a more sustainable economy and seems to some extent an inevitable characteristic of this transformation. From this perspective completely protecting SMEs from the expectation to share certain sustainability information may have the unintended effect of excluding them from the business opportunities of the transition, including access to green finance.

41 The strategy in Europe has therefore been a) to limit the trickle-down effect where possible and b) considering that the trickle-down effect cannot be stopped completely, to help SMEs cope with requests for sustainability information. This is reflected in EFRAG's work on the ESRS LSME and VSME.

42 In particular concerning point a) above, ESRS LSME determines the so called-value chain cap to limit the trickle-down effect. According to the CSRD, the European Sustainability Reporting Standards (ESRS) for large companies cannot include reporting requirements that would require the reporting company to obtain from SMEs in its value chain information the exceeds the information that listed SMEs have to report according to the proportionate standards for listed SMEs, i.e., the LSME ESRS. It has to be highlighted that the ESRS prescribe very few specific quantitative data points that require companies to seek specific data from suppliers (for example scope 3 GHG emissions and the procurement of substances of concern). As additional safeguards the ESRS state that for the first 3 years of reporting: a) when reporting metrics, companies are not required to report value-chain information, except for certain datapoints; and b) when reporting on policies, actions and targets, the company may limit its reporting to available in-house information (such as data already available to the company or publicly available information). Finally, the ESRS recognise there may be cases when the company cannot collect the necessary value chain information in the supply chain after making reasonable efforts to do so. In such cases, the company can rely on estimates instead.

43 On the other hand, concerning point b) above, ESRS VSME aims to help non-listed SMEs to respond to requests for sustainability information that they may receive from their business counterparts considering that the trickle-down effect cannot be completely stopped. Hence ESRS VSME can be a tool to facilitate and reduce the burden, defining the set of information that it is reasonable to expect SMEs to provide.

4. CONCLUSIONS

44 Global and European commitments, including the Paris agreement, the UN sustainable development goals and the EU green deal rely on effective, robust and interoperable corporate sustainability reporting frameworks to achieve their full potential.

45 This input paper discusses the challenges and strategies for sustainability standard setting, with specific focus on the burden reduction and proportionality dimension as drivers of benefits in the medium and longer-term. The paper describes the concrete European case and how the Corporate Sustainability Reporting Directive addresses some of the standard setting questions as well as what potential challenges and benefits are associated with it. Focus is provided on the European Sustainability Reporting Standards and to their pivotal role to meet the ambitious EU green deal goals.

46 The paper delves into the methodological approach to proportionality and simplification to be considered when introducing sustainability reporting frameworks for SMEs. SMEs are essential economic actors, and they are an important component of the value chain of larger companies, investors or financial institutions.

47 The paper discusses and describes in detail the approach adopted in the standard setting process by EFRAG for the two SME proposed standards that are currently under public consultation as exposure drafts. Some of those simplifications have been inspired by the approach taken by the EC in the ESRS for large undertakings, some others have been specifically developed to fit the capacities and characteristics of micro, small and medium-sized undertakings and their scale and complexity.

48 This input paper also argues that similar considerations / similar simplifications adopted by EFRAG in the standard setting process for SMEs may be relevant and may be replicated or may be explored for less resourced entities at large (i.e., companies in lower income countries)

49 The current public consultation on both EFRAG SME sustainability reporting standards, the one for listed SME (LSME ESRS ED) and the one for non-listed micro, small and medium sized entities (VSME ED) will (hopefully?) provide answers to key questions discussed in the methodological approach to simplification. Evidence based feedback on implementation challenges, costs and benefits will also be provided as part of the field tests that EFRAG is running in parallel to the public consultation.

50 The fact that companies ask SMEs/suppliers for sustainability information is to some extent an inevitable characteristic of the sustainable economy and therefore regulators and policymakers should not aim to completely exclude or “protect” SMEs from the expectation that they share certain sustainability information, since to do so would have the perverse effect of excluding them from the business opportunities of the transition, including access to green finance. Regulators across the world should therefore consider how a) to limit the trickle-down effect where possible and b) knowing that there may inevitably be some degree of trickle-down effect, to help SMEs cope with requests for sustainability information when they are exposed to such requests, in particular through implementation support and practical tools similar to the ones already available for financial reporting.

51 Crucially, the evolving framework and the availability of simplified tools for SME’s ESG reporting is expected to stimulate more consistent and reliable data and thereby support overall the climate and sustainable transitions.

[i] Council Conclusions on the Deepening of the Capital Markets Union, 5 December 2019