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European Sustainability Reporting Standards: From Theory to Practice

Position Paper by Practitioners

ESRS Guide

OF DEUTSCHES AKTIENINSTITUT

Deutsches Aktieninstitut

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Insights from practitioners: A guide to implementing the ESRS

The Corporate Sustainability Reporting Directive (CSRD) and the European Sustainability Reporting Standards (ESRS) establish a new framework for corporate sustainability reporting. The ESRS outline the requirements for what and how companies must disclose material impacts, risks and opportunities related to sustainability aspects in the areas of Environment, Social and Governance (ESG), following the principle of double materiality. In Germany alone, around 15,000 companies are subject to this reporting obligation.

Implementing these standards presents significant challenges due to the extensive amount of information required to be reported and the complexity of the subject matter. Additionally, reporting under the new standards is an uncharted legislative territory for companies, auditors and supervisory authorities. In addition, the broad scope for interpretation of the ESRS currently hinders truly standardised reporting.

This position paper aims to contribute to the discussion on practical implementation from the perspective of practitioners. It seeks to share the experiences of participating companies, provide insights into challenges encountered, and highlight ways to address them. The practical recommendations listed reflect the realities faced by the participating companies and can assist other companies with their implementation, regardless of whether they are in the midst of implementing the ESRS or just beginning.

From May to July 2024, member companies of Deutsches Aktieninstitut collaborated in four working groups to develop explanations on topics such as the definitions of terms, scope of consolidation, the concept of double materiality and the internal control system (ICS) for sustainability reporting. The meetings also included discussions with colleagues from major auditing firms, whom we would like to thank for their constructive dialogue on the ESRS implementation. There may be differing opinions on specific individual issues related to the four topics.

References are made to both the individual ESRS standards and commentary literature. However, this document does not claim to be exhaustive and represents a snapshot of the discussion as of July 2024. Sustainable reporting is still evolving and will continue to develop in the future.

Executive Summary

1. Double materiality

The European Sustainability Reporting Standards (ESRS) clarify the concept of double materiality outlined in the Corporate Sustainability Reporting Directive (CSRD) and expand a company's reporting scope to its entire value chain. This concept requires companies to identify reportable topics by assessing the impacts, risks and opportunities (IROs) arising from the company's interactions with the environment and society.

Contrary to the EU taxonomy, the ESRS do not prescribe fixed criteria for assessing materiality. Instead, companies and their respective management are responsible for defining the criteria and determining the thresholds for when IROs are considered material. The comments on double materiality reflect the initial practical experiences of the participating companies, highlighting the challenges they face and offering initial solutions. The structure of these explanations is based on EFRAG's Implementation Guidance IG1 on Materiality Assessment (EFRAG IG 1), published at the end of May 2024.

2. Scope of sustainability reporting

This section on defining the scope of consolidation for sustainability reporting addresses the practical nuances of determining the scope of consolidation and the reporting entity under the CSRD. While the CSRD generally aligns the scope of consolidation with that of financial reporting, there are specific deviations and peculiarities in the context of sustainability reporting.

Firstly, under certain circumstances, the CSRD requires disclosures on subsidiaries that are not included in the financial scope of consolidation due to immateriality for financial reporting purposes. Secondly, the general IFRS scope of consolidation for certain environmental topics is extended to include the concept of operational control. This chapter outlines criteria for defining the term "operational control" and illustrates the practical challenges of implementing ESRS E1-6 through practical examples.

3. Definitions of terms

This section provides definitions and explanations of selected terms related to the ESRS standards. It aims to offer guidance on interpreting and applying key concepts and requirements of the ESRS from a business practice perspective. For example, topics such as CapEx/OpEx, climate transition plan, value chain or consumer/end user are addressed.

The working group focused on issues identified by its members that are currently under discussion in corporate practice regarding ESRS implementation and where there is a need for interpretation.

4. Internal control system for CSRD/ESRS sustainability reporting

The new CSRD requirements are complex and require the establishment of an effective Internal Control System (ICS) for data collection, processing and reporting. Implementing such an ICS poses challenges for companies, as mature structures for sustainability reporting ICSs are often lacking. ESG KPIs and information must be selected and prioritised based on various key factors, including relevance for corporate management, internal and external reporting requirements and the quantifiability of ESG information.

An effective ICS enhances the reliability of the information provided. When implementing and adapting the ICS, it is crucial to assess current needs and risks. Companies should consider both centralised and decentralised processes and involve experts for existing ICSs to ensure efficient implementation.

This section on the ICS for sustainability reporting deals with various issues companies face when implementing the ICS for ESG data. It first presents the regulatory requirements for an ICS for sustainability reporting. It then examines various fundamental factors to be considered such as the content and organisational structure of an ICS for sustainability reporting and the possible prioritisation of ESG information. Finally, it offers recommendations for business practice.

1 Double materiality

1.1 Double materiality: Summary/Core statements

The ESRS specify the concept of double materiality and extend the reporting boundaries of a company to its entire value chain. According to this concept, reportable topics are to be identified by assessing the *impacts, risks and opportunities* (IROs) in the company's interaction with the environment and society.

Contrary to the EU Taxonomy, the assessment of materiality is not determined by fixed criteria in the ESRS. In particular, the detailed definition of the criteria, the assessment including reasoning and the determination of the threshold values for materiality are within the responsibility of the company and therefore the decision of its management.

Most of the participating companies took three to six months to carry out the initial materiality assessment in accordance with the CSRD (before coordination with the auditor). A final statement cannot yet be made as internal discussions continue and the coordination with the auditor is still pending or needs to be finalised.

The following explanations show initial practical insights of the participating companies, current challenges and offer initial solutions. The structure is based on the materiality assessment process as presented in EFRAG's Implementation Guidance IG1: Materiality Assessment (hereinafter referred to as EFRAG IG 1) which was published at the end of May 2024 and sets out five steps as part of the materiality assessment:

- Step A: Understanding the context
- Step B: Identification of IROs
- Step C: Assessment and determination of the material IROs
- Step D: Validation of IROs and evaluation by internal and external stakeholders
- Step E: Identification of material topics for sustainability reporting

1.2 Fundamentals of the materiality assessment

ESRS 2: IRO-1; ESRS 2: SBM-3, ESRS 2: MDR-M

1.2.1 Responsibility for the materiality assessment

Due to the comprehensive nature of the environmental, social and governance (ESG-)dimensions, conducting a materiality assessment poses a considerable challenge for companies. As a rule, there are no organisational structures that allow all three dimensions to be covered by one department.

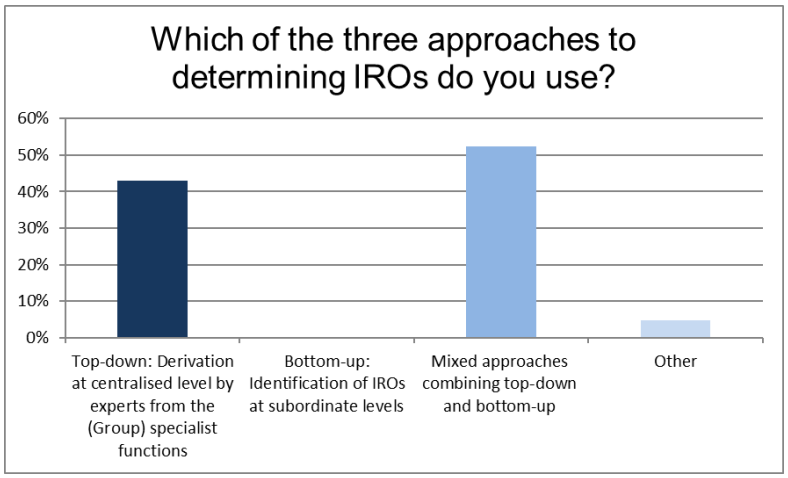


Illustration 1: Coordination of the materiality assessment
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

Accordingly, the companies represented in the four working groups of this ESRS guide that answered the survey do not yet have a uniform process for carrying out the materiality assessment. It is usually carried out jointly by different departments and experts within the company.

The main roles can be divided as follows:

- Organisation/coordination (project management)
- Methods (e.g. with the Enterprise Risk Management team, but possibly also in collaboration with the ESG-related expertise/specialist departments (content owners))
- ESG-related expertise/specialist areas (content owner)

For the participating companies, the responsibility for coordinating the materiality assessment is shown in Illustration 1.

The initial materiality assessment is often carried out with external support as developing methods for the various questions, identifying IROs and assessing the material topics is a highly complex exercise. The annual repetition, however, may be assigned to the department responsible for with reporting and/or involved in the preparation of the management report (e.g. Investor Relations or Accounting).

If a Sustainability Department exists, it is recommended to assign the latter with the responsibility for the materiality assessment since it requires a broader understanding of the concept of sustainability within the company. The responsibility of the Sustainability Department should not only include the environmental dimension, but also at a minimum the social dimension.

Alternatively, the process can also be managed by the Legal or Finance Department, whereby coordination can be carried out by the Investor Relations Department, but theoretically also by the Enterprise Risk Management team.

For an overview of the specialised functions that may need to be involved, see chapter 1.5.3.

1.2.2 Governance, approvals, involvement of works council

The discussion and approval of the results of the materiality assessment are very company-specific and are directed at various positions with different remits or assignments and seniority.

Possible ESG governance bodies include the Sustainability Board, Sustainability Council, ESG Committee or alternatively the Management Board. In some cases, involving the Sustainability Strategy or Risk Management Department (if existing) might be necessary.

The following aspects are also important:

- Formal approval should be given by the responsible *Management Board member* (e.g. COO, CFO) or the entire Management Board.
- The *works council* must always be informed and involved as a stakeholder (proxy for stakeholder "own employees"). The timing and scope are company specific. However, the involvement should take place before the Audit Committee is informed.
- The *Audit Committee* should be informed, as the *Supervisory Board is responsible for* the reporting as a whole due to its role as the body issuing the mandate.
- The *auditor* should be involved at an early stage to ensure that the materiality assessment complies with audit requirements.

1.2.3 Tool support

Numerous software tools are currently under development, although not all available tools fulfil the criteria of the CSRD/ESRS. No product has yet gained widespread acceptance. The majority of the companies involved use Excel or in-house tools, while some also incorporate analyses and data from external ESG software providers into the process.

When launching the process for the first time, it may make sense to work without special tools. Subsequently it may be useful to use a tool, for example if a large number of IROs have been identified.

1.3 Step A: Understanding the context

ESRS 2 IRO 2: ESRS AG 63 in conjunction with 64a), AG 66a)ii), AG 73; ESRS 2 5c), ESRS 2 42c SBM-1; ESRS 2: IRO-2 59

To understand the context, each company should consider the scope of the various components (i.e. business models, value chain, stakeholders, different global reporting requirements) at an early stage and with sufficient flexibility in time, depending on the complexity of the business model and the business areas, in order to ensure that the basic information for the materiality assessment is complete.

The understanding of the context is the basis for starting the materiality assessment in accordance with EFRAG IG 1. The following chapter is intended to provide reporting companies with ideas and suggestions as to which activities can be undertaken. These activities are not compulsory but are to be understood as helpful suggestions on how the authors and companies of this paper operate.

1.3.1 Research

1.3.1.1 Building on existing (corporate) activities and contacts

a) Analyses of macroeconomic trends, market studies and screening of the company environment

   Possible contacts: Research House, Marketing Department, Strategy Department

b) Analyses of business micro-trends/SWOTs/Porter/BCG matrix

   Possible contacts: Strategy Department, Investor Relations

c) Analyses of stakeholder mapping with an overview of NGOs, employees, suppliers, customers, investors, local companies, legislatures, regulators, etc.; for information on the inclusion of stakeholders in this and the following steps of the materiality assessment, please see the detailed description in section 1.6.1.

   Possible contacts: Research House, Marketing Department, Strategy Department

d) Annual/regular evaluation of top stakeholders: Suppliers, customers, investors

   Possible contacts: Procurement/Purchasing, Product Department, Marketing Department, Strategy Department, Sales Department, Finance Department

e) Collection/overview of the top topics for investor relations enquiries and RFPs

   Possible contacts: Investor Relations, Marketing Department, Strategy Department, Sales Department

f) Utilisation of due diligence processes; the customer is also considered in these processes

   Possible contacts: Marketing Department, Strategy Department, Sales Department, Risk Department

g) Depending on the existing regulatory/strategic environment: stress testing/business continuity models/life cycle analysis

   Possible contacts: Marketing Department, Strategy Department, Sales Department, Risk Department, Product Department

h) Presentation and definition of the key roles in the value chain

Possible contacts: Finance Department, Strategy Department, Risk Department, Product Department

i) Exchange with peers at specialist conferences, meetings and (virtual) events, subject to compliance with company-specific policies on exchange with competitors

1.3.1.2 Use of external services

For further support, it is sometimes advisable to use external services (not traditional consulting). Positive experiences have been made with the following services:

- Collaboration with artificial intelligence boutiques to carry out social media analyses, media analyses, trend topics in the corporate context
- Exchange with rating agencies (financial/non-financials) that already rate the company, e.g. CDP, S&P, Moody's, Morningstar
- Commissioning of stakeholder/shareholder/customer surveys
- Commissioning of competition analyses

1.3.2 Clustering the research

In practice, there are basically two ways of structuring the results of the research:

- According to *internal (recurring) focus areas,* taking into account the key components of the specific business model, value chain, geographical positioning, visibility in the market, vision, mission, etc.
- According to *external (recurring) focus areas,* taking into account unique selling propositions, focus on the value chain, ability to adapt and innovate with regard to the changing market environment, megatrends, etc.

1.3.3 Evaluation

Firstly, the internal and external context is presented. You should ask yourself the following questions:

- Are there overlaps?
- Where do synergies arise?
- Where do conflicts arise with regard to the various requirements?

The evaluation can already serve as potential preliminary information for IROs (see chapter 0). This is followed by validation by internal experts and external stakeholder groups:

- *Internal experts:* employees, works council, management
- *External experts:* consultants, investors, customers, suppliers, NGOs, other affected interest groups

1.3.4 Documentation, monitoring and regular review in cooperation with identified departments

Detailed documentation throughout the entire process is recommended. It should be frequently adapted and updated. The documentation should include the following points, among others:

- Overview of dialogue partners and roles, invitations
- Description of the methodology, definition of categories, criteria
- Results, minutes of meetings, contributions, adjustments, changes

To keep the documentation up to date, regular reviews (e.g. annually) should be carried out. The department responsible for coordination (see chapter 1.2.1) initiates the review, carries out an initial check and, if necessary, an update of all steps. The review typically occurs outside the reporting phases or directly after reporting (e.g. Q2/Q3) or if specifically required by a triggering event (reorganisation, new business areas, acquisitions, incidents, etc.).

The other specialist functions involved in the risk analysis should also be involved in a regular dialogue. Furthermore, a close dialogue with Risk Management – at least every six months, preferably once a quarter and in the event of changes – is advisable.

1.3.5 Value chain

The first approach to materiality assessment is usually rather pragmatic and it is not always possible to carry out a complete analysis of the value chain. In addition to the company's own activities, the focus is on key topics and partners in the value chain.

A graphical presentation of the value *chain* (*value chain mapping)* is recommended. The supply chain *(upstream)* is usually already more transparent than the customer side (*downstream*) due to existing data collection processes, for example with reference to the German Supply Chain Due Diligence Act (Lieferkettensorgfaltspflichtengesetz – LkSG).

Illustration 2: Exemplary representation of the value chain
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

For further recommendations regarding the value chain, please see the EFRAG Implementation Guidance IG 2: Value Chain.[1]

1.4 Step B: Identification of IROs

ESRS 1: AR 16; "Disclosure requirements in connection with ESRS 2 IRO-1" in E1 to E5 and G1; ESRS 2: SBM-1, ESRS 2: SBM-3, ESRS 2: MDR-M

1.4.1 Key experiences & challenges so far

When identifying the IROs, the following challenges for the participating companies have been noted which are discussed in more detail below:

- Which approach is recommended for identifying IROs: top-down or bottom-up?
- What are suitable sources for identification?
- What is a common number of identified IROs?
- Is it useful using a software tool?
- Which IROs are company-specific and which are not?

Note: If a company falls under the reporting requirements of the SFDR and already reports PAIs, it is worth taking a look at whether these can be used to substantiate negative impacts.

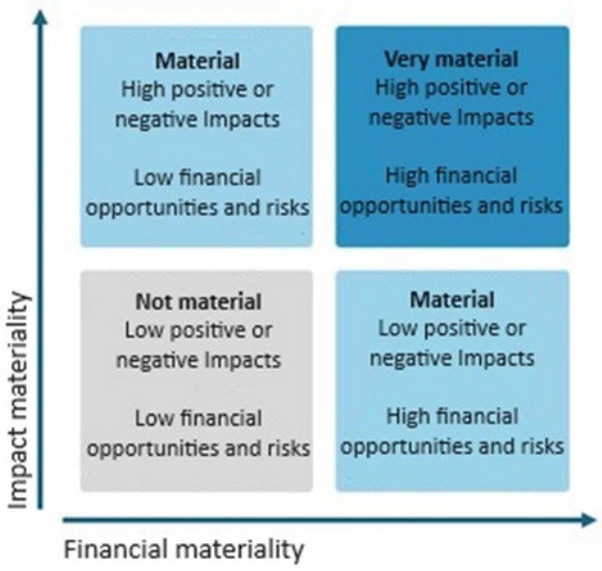


Illustration 3: Matrix of impact materiality and financial materiality
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

1 https://www.efrag.org/sites/default/files/sites/webpublishing/SiteAssets/EFRAG%20IG%202%20Value%20Chain_final.pdf

1.4.2 Best practice

Various approaches can be observed in practice when determining IROs:

- **Top-down:** Identification on the corporate level by experts from the (group) specialist functions
- **Bottom-up:** Identification of IROs at subordinate levels, for example at the level of individual business units or subsidiaries, with subsequent aggregation at group level
- **Mixed methods:** Combination of top-down and bottom-up approaches

In principle, the choice of procedure is up to the company. Initial experience shows that most companies have chosen a top-down process. Fewer companies determine and evaluate IROs using a bottom-up approach.

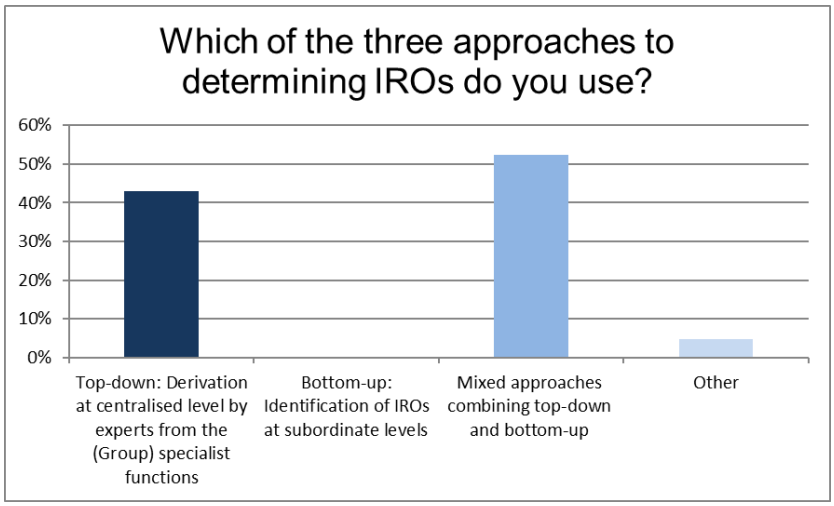


Illustration 4: Approaches to determining IROs
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

Stakeholder involvement is already relevant in the process of identifying IROs.

It is recommended to use the list of topics (including sub-topics and sub-sub-topics) in AR 16 of ESRS 1 as a starting point for the materiality assessment (*long list*).

In addition, potentially material topics and related IROs may be identified with the materiality assessments previously carried out as part of the reporting in the non-financial statement or in a sustainability report in accordance with common international frameworks (if necessary, an allocation of previous topics to the ESRS subtopics is required). Furthermore, previous reporting, the company's presence in the media and current procedures/incidents could be a hint. Moreover, an analysis of the existing business portfolio and the markets served by the company, which must be described in ESRS 2 – SBM-1, is necessary to derive the topics.

If topics cannot be assigned to the ESRS (sub)topics, specific topics may need to be defined/added as entity-specific topics (e.g. cybersecurity; see section 1.4.3).

To identify the IROs, including the related sustainability aspects for each identified (sub)topic, it has been helpful to first cluster the consolidated and non-consolidated subsidiaries by business activity, as the sustainability aspects may be assessed differently depending on the business activity.

Starting points for identifying the effects can be findings from due diligence processes already implemented in the company (and for companies within the scope of the Supply Chain Due Diligence Act, also findings from the corresponding process). Concerning topics for which such findings have not already been obtained through other processes, it is helpful to be guided by the disclosure requirements to identify key figures. For example, for a materiality assessment in the area of pollution, it is useful to determine which pollutants emitted by the company must be reported in accordance with ESRS E2-4.

For the identification of risks and opportunities, the company should use the existing register of risks and opportunities set up by the Risk Management Department as a starting point. If necessary, this register should also address the individual sustainability topics even if they are recorded in the risk management system in aggregated form.

Ideally, the value chain (including the supply chain) should also be analysed and clustered to collect and evaluate the associated aspects (IROs). Depending on the business model and degree of maturity, many companies only succeed in analysing the value chain (essentially the supply chain) more systematically for this purpose and deriving the IROs in the second round or later.

Most companies identify around 100 IROs (top-down or counterflow procedure). In the bottom-up process, numerous decentralised IROs are collected (>100-500), which are then in turn clustered/aggregated.

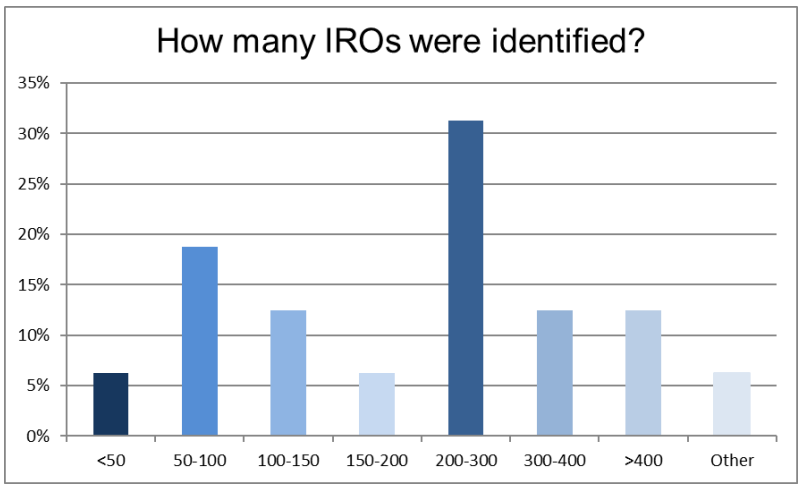


Illustration 5: Number of identified IROs
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

An average of 80 IROs were identified as material for the companies involved (of which around 25 were identified as financially material and 55 as having a material impact).

The ESRS themselves also contain a number of useful tips on how to proceed with the materiality assessment. These can be found in the environmental standards E1 to E5 and in the governance standard G1 under the sub-item disclosure requirements in connection with ESRS 2 IRO-1. It is also important to note here that the disclosures prescribed under these sub-headings must also be included in the sustainability statement if the respective standard was assessed as immaterial in its entirety, as they systematically form part of the (mandatory) disclosures in accordance with ESRS 2. For the standard S1 Own Workforce, criteria to be considered when analysing materiality can be found in Appendix A.1 (*important*: the appendices are an elementary component of the standards and must be observed in the same way). The other standards from the social area (S2 to S4) do not contain any direct requirements or criteria for the materiality assessment.

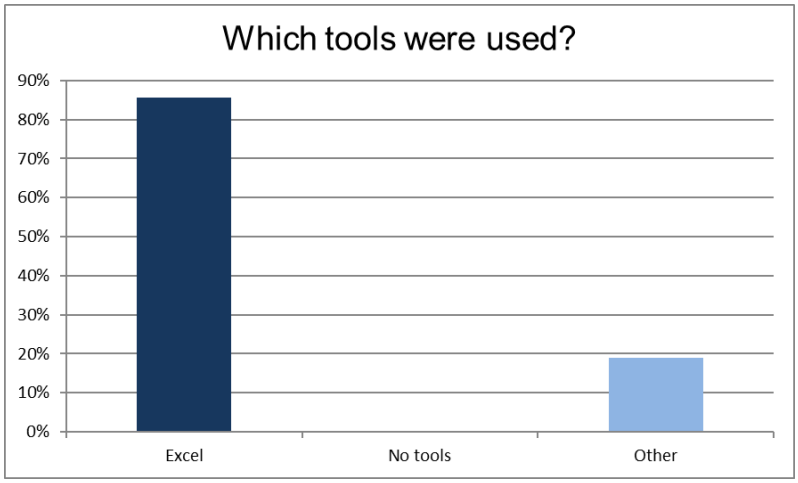


Illustration 6: Tools used to carry out the materiality assessment
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

1.4.3 Entiy-specific IROs & sustainability topics

Depending on the industry, further topics, for example ESG criteria from investment management, must be taken into account as *entity-specific IROs.* Until the sector-specific standards become available in Set 2 (summer 2026 at the earliest), it is recommended that the content of other globally applied frameworks, in particular the standards of the Global Reporting Initiative (GRI) and the standards of the Sustainability Accounting Standards Board (SASB), which have now been incorporated into the ISSB standards, are also used to identify entity-specific topics.

Furthermore, the participating companies identified additional entity-specific IROs. In most cases, one to three additional, entity-specific topics are identified, often including cybersecurity/data security, digitalisation and responsible AI.

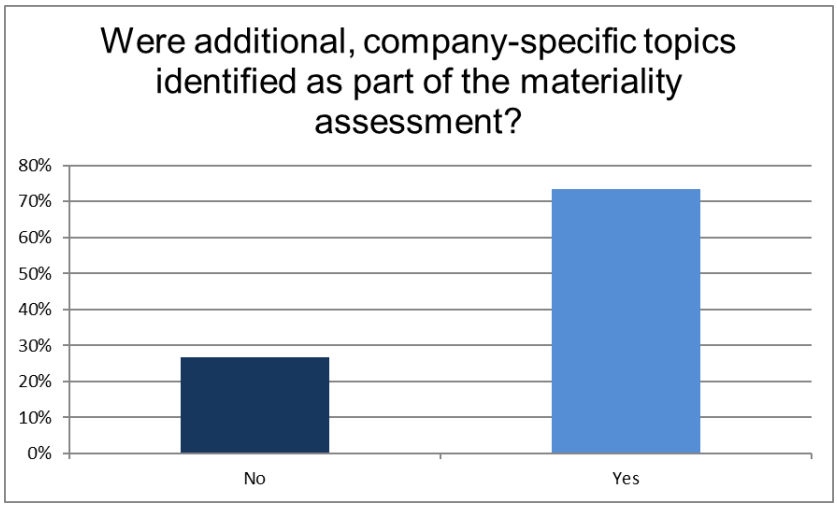


Illustration 7: Company-specific IROs
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

1.5 Step C: Evaluation and determination of the material IROs

ESRS 2: IRO-1, ESRS 2: IRO-2, ESRS 2: MDR-M

1.5.1 Key experiences & challenges to date

The assessment of sustainability topics on the basis of IROs is still subject to many uncertainties and challenges given its new and evolving nature. Unlike the EU taxonomy, the ESRS do not set up mandatory absolute or relative thresholds but assign the responsibility for assessing materiality to the company's management. In addition, qualitative as well as quantitative assessment criteria must be used.

Practical note: When assessing and determining the material IROs, consistency with risk management must be ensured.

1.5.2 Definition of the criteria and determination of the materiality threshold

Potential impact			
	Actual impact		
Probability	**Severity**		
(only for potential effects)	**Scale** How severe are the effects on people and the environment?	**Scope** How widespread are the effects?	**Irremediability** How difficult is it to counteract this?

Table 1 Example of an impact assessment table (here: negative impact)

The assessment criteria for impact and financial materiality are listed in ESRS 1 in subchapters 3.4 and 3.5. Many companies copy these criteria and the rating scale to an Excel spreadsheet (separately for impact and financial materiality) in order to assess the IROs.

Practical note: When assessing financial materiality, it is highly recommended to rely on the processes and valuation logic of risk management to the largest extent possible.

Financial materiality: The first step should be a discussion to ensure a common understanding of financial materiality with risk management. As risk management generally already has a structured process in place, it makes sense to adopt the same "reporting threshold" for the materiality assessment to ensure consistency with the risk report in the management report.

In current practice, however, the established risk management system does not necessarily cover all the requirements of the ESRS, particularly regarding the long-term time horizon, but also with respect to different approaches to determining gross and net risks. Based on the information from the existing risk management, the identified risks are therefore regularly expanded as part of the materiality assessment.

The assessment methodology for risk management and ESG risk identification may differ in some cases. It should be ensured that the format and the level of details of ESG aspects are included in the risk management and that the newly identified risks are addressed in the management processes (if necessary, new risks should be integrated into existing risks).

Practical note: The materiality assessment may identify new risks that are not (yet) part of the existing risk management (scope is not identical). As the materiality assessment progresses, an expansion of the risk management process should be discussed to add aspects that are not (yet) covered by financial risk management (longer time horizons, scope, etc.). In principle, there is room for manoeuvre for companies here.

Materiality threshold

A suitable threshold is necessary to identify the material sustainability topics that are to be reported. It should be considered that sustainability topics already anchored in the company's (sustainability) strategy are material. In addition, peer reviews and the views of (internal/external) stakeholders involved can be taken into account when determining the thresholds. It is recommended to align the thresholds with the auditors.

The standards listed in Figure 8 were identified as essential by the participating companies.

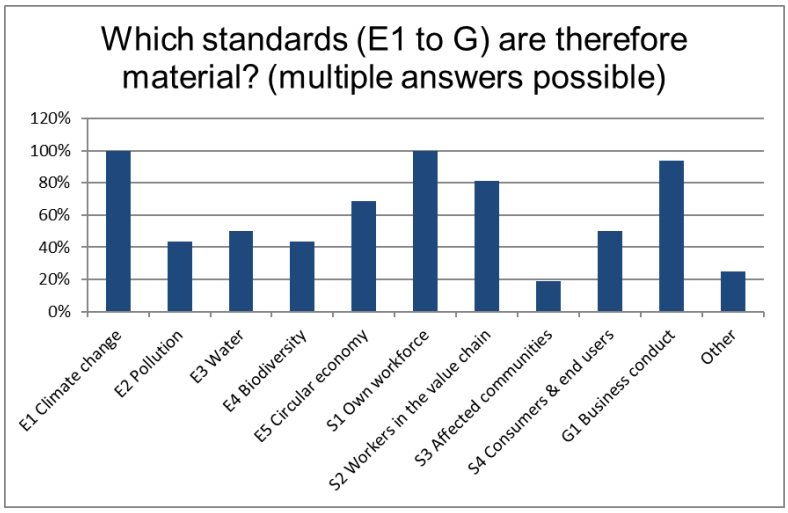


Illustration 8: Material standards
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

These results are consistent with the results of other surveys and case-studies published in the meantime by the Accounting Standards Committee of Germany (ASCG) with regard to DAX 40-companies[2] and the University of Cologne on the early initial application of ESRS in the EU[3].

The participating companies identified an average of 17 sub-topics as material (minimum 13, maximum 27).

The standards shown in Figure 9 were not identified as material by the participating companies.

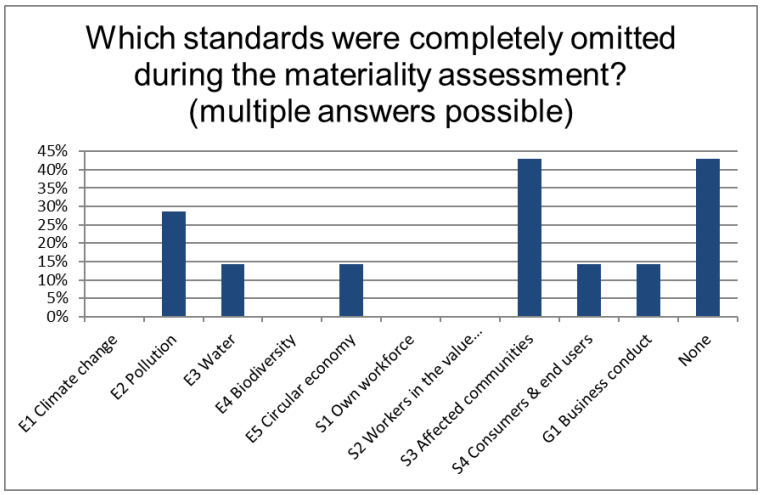


Illustration 9: Immaterial standards
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

2 https://www.drsc.de/app/uploads/2024/07/2024_07_12_Bericht-DAX40-Stand_der_Wesentlichkeitsanalyse.pdf
3 https://sustainabilityreportingnavigator.com/csrd-dma-analysis.pdf

1.5.3 Involving experts/specialists

In practice workshops (depending on the prevailing experience in the company, current disclosure measures, organisation of the company), in which the experts explain and justify their assessments across departments have proved to be successful in order to achieve a uniform and non-biased assessment.

To achieve this the evaluation pattern of the individual functions (expert evaluation vs. cross-functional evaluation) must be balanced against each other (generally higher/lower).

The expertise for impact materiality tends to rather come from the sustainability experts or specialist functions in the environmental and social area, while Finance/Risk Management Departments and the scales and materiality thresholds of enterprise risk management are used for financial materiality. The expertise for social issues is often linked to the Human Resources Department, while the specialist functions of the Purchasing Department and the Compliance Department can contribute with their expertise on the value chain.

It is recommended to involve experts from the following subject areas (non-exhaustive list):

- For *environmental standards:* climate protection/greenhouse gases (GHG accounting), environmental pollution, water management, waste management.
- For *social standards:* HR Department, occupational health and safety, equal rights officer, remuneration, training, works council and also Legal Department, in particular human rights.
- Experts from the Finance Department (Risk Management, Accounting, Controlling) must also be involved in determining *risks and opportunities* and assessing them.

The expertise for the materiality assessment was distributed among the participating companies as follows:

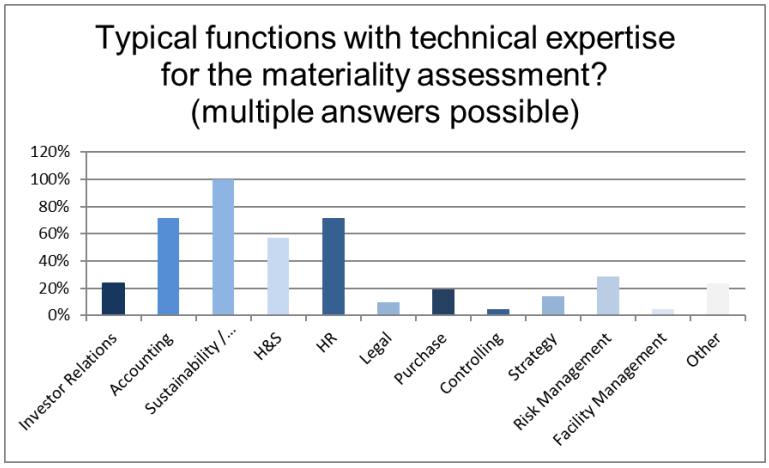


Illustration 10: Expertise for the materiality assessment
(Source: Working Group on Double Materiality of Deutsches Aktieninstitut)

1.5.4 "Gross" assessment of risks and impacts

When dealing with the "gross" assessment of impacts and risks, it is important that the overall situation is presented truthfully. This principle is anchored in ESRS 1 as a fundamental qualitative characteristic of information and is intended to ensure the usefulness of information for decision-making.

In most cases, the (financial) risk management approach already includes a realistic net assessment. In the specific ESG assessments, measures that have already been implemented must be taken into account, particularly to avoid an unrealistic presentation of a hypothetical impact. Neither an overestimation nor an underestimation should be made to ensure truthful presentation as a basic principle of reporting.

EFRAG IG 1 distinguishes in FAQ 23/§§ 228-233 and once again a clear statement that despite the "gross" principle being applicable for actual impacts, measures that have already been implemented must be taken into account. It also explains the understanding of potential impacts that must follow the gross approach.

Practical note: Issues with an actual impact in particular are not necessarily material because extensive measures have been implemented and the impact would be significant without them.

Examples: Imagine the risk identification for a car. Existing safety precautions are taken into account, i.e. seat belts and brakes, which have been implemented as safety measures for decades. Without this consideration, hypothetical risks would result in materiality, but this would hardly provide any new insights and would not affect the usefulness of the decision.

The same applies, for example, in the context of water extraction and utilisation. Tightly meshed legal and authorisation requirements have been in place for years (in Germany) to protect people and the environment and prevent critical environmental impacts. If these implemented measures result in a limitation of thresholds being respected and the goal of protecting people and the environment being achieved, the issue is unlikely to be material due to the actual impacts.

1.6 Step D: Validation of the assessment by stakeholders

ESRS 1.AR 7; ESRS2: SBM-2 45a -to 45d

1.6.1 Key experiences & current challenges

Involving stakeholders is an essential part of the materiality assessment.

ESRS 1.22 distinguishes between *affected stakeholders* on the one hand and *users of sustainability statements on* the other; however, this distinction is not free of overlap.

Affected stakeholders are defined as individuals or groups whose interests are or could be positively or negatively affected by the company's activities and business relationships (across entire value chain).

The challenge in practice is that not all affected stakeholders are directly recognisable throughout the value chain, especially if they are only indirectly affected. Companies must therefore ensure that all materially affected stakeholders are recognised in order to ensure complete and appropriate reporting. Not all stakeholders are affected by the company's activities to the same extent. As a general rule, *key stakeholders* affected are

- Investors
- Customers, including consumers and end users
- Own workforce
- Suppliers, including their employees

In addition, nature is regarded as a so-called silent stakeholder in the ESRS (ESRS 1.AR 7).

Practical tip: The intensity with which different stakeholders are affected by the company's activities can vary. Therefore, the most important affected stakeholders must be carefully identified.

Involving affected stakeholders in the materiality assessment will deliver deeper insights into the effects of the company's activities while reflecting on these from the perspective of the stakeholders. However, the overall responsibility for conducting the materiality assessment and thus determining the material sustainability aspects remains with the company.

The ESRS themselves do not prescribe a binding procedure for the materiality assessment. However, they do emphasise the importance of a dialogue with the affected stakeholders as part of the materiality assessment. There is not necessarily a need for a direct dialogue – an analysis via proxies (internal functions that regularly interact with stakeholders and are capable of providing information on a proxy basis, see below) is also possible.

The materiality assessment requires companies to adopt the perspective of the affected stakeholders to assess the severity and likelihood of impacts. Various approaches are possible for this, which are not limited to direct dialogue. For example, representatives such as employees of affected departments, trade unions or NGOs can also be consulted. In addition, companies should use existing internal and external information from previous interactions with stakeholders.

Involving stakeholders is possible and helpful in every phase of the materiality assessment, whereby the involvement fulfils a separate purpose in each step. The ESRS only require reporting to the extent and form of stakeholder involvement in the materiality assessment. However, they do not specify how this involvement must be organised.

Practical tip: External stakeholders often find the number and variety of topics challenging. The appropriate level must be identified for the discussions (at the level of the standards, at most at the level of the sub-topics but not at the level of the IROs). Proxies are therefore often used.

1.6.2 Best practice

The use of existing processes and the analysis of proxies is a suitable way to include the perspective of affected stakeholders.

The following sources are possible, among others:

- An analysis of the questions asked by shareholders at the last Annual General Meeting(s)
- Findings from existing due diligence processes in Purchasing and Sales Departments
- For entities that are materially covered by the EU taxonomy, an analysis of the existing documentation on *substantial contribution*, *do no significant harm (DNSH)* and *minimum safeguards* (for further details see also FAQ 25 of EFRAG IG 1)
- The ESG rating criteria that the company considers to be material
- Information requirements of investors in accordance with the SFDR
- Scientific reports for environmental standards E1 to E5 as a proxy for nature as a silent stakeholder (ESRS 1.AR 7)
- Internal surveys on employee satisfaction

In general, not every need of every affected stakeholder can be mapped to the same extent via proxies. In such cases, stakeholder surveys using suitable instruments are recommended. It should be noted that stakeholders should only comment on issues for which the relevant expertise is available. A one-size-fits-all approach to stakeholder surveys will usually not be useful.

The involvement of stakeholders as part of the materiality assessment must be documented in an appropriate format. This documentation can also form the basis for the mandatory disclosures on ESRS 2 – SBM-2 Stakeholder Interests and Views.

A complete analysis (complete mapping of the relevant stakeholder perspectives) must be ensured at the time of reporting. The goal is continuous stakeholder interaction, for example also embedded in existing forms such as investor communication.

1.7 Step E: Identifying the material topics for sustainability reporting

Even after the assessment of the IROs and the resulting material topics, further challenges and questions of interpretation arise. One possible challenge in step E is that (sub-sub-) topics do not always correspond to disclosure requirements. Please refer to EFRAG ID 177 – Links between AR16 and Disclosure Requirements for more information.[4]

4 https://www.efrag.org/system/files/sites/webpublishing/Meeting%20Documents/2406201146237832/04-02%20ID%20177%20draft%20explanation.pdf

In addition, after identifying the material topics in the context of the sustainability reporting, it is possible to assess individual disclosure requirements in the area of key performance indicators or data points as immaterial if it can be demonstrated that the key performance indicator or data point does not provide any relevant information for assessing the effectiveness of the management of an impact (see also Appendix E "decision tree" to ESRS 1).

However, "too much effort" is not an argument for not considering data points. We refer to a future follow-up on this topic.

Finally, it is likely that most companies will adopt the proposed structure of the ESRS for the sustainability statement (see, for example, ESRS 1 Appendix F). The wealth of information that needs to be provided suggests that a structure should be followed that makes it easy for readers to find the information relevant to them in a coherent way, focussing on the truly material disclosures.

Note: For the scope of sustainability reporting and a comparison with financial reporting, please refer to the following section of the Scope of consolidation working group.

2 The scope of sustainability reporting

2.1 Basics

According to Article 29a(1) of the Accounting Directive as amended by the CSRD, parent companies of a large group shall include in the consolidated management report information necessary for an understanding of the group's impact on sustainability aspects and the impact of sustainability aspects on the group's development, performance and position. A group within the meaning of the Accounting Directive is "a parent undertaking and all its subsidiaries" (Article 2 No. 11 of the Accounting Directive). According to Article 21 of the Accounting Directive, the scope of consolidation therefore includes the parent company and all of its subsidiaries.

Consequently, ESRS 1.62 clarifies that the sustainability report refers to the same reporting entity that prepares the financial report. If the reporting entity is therefore a parent company that is obliged to prepare consolidated financial reporting, the sustainability report must also be prepared for this group. The following applies to the scope of consolidation "*a group is defined as a parent undertaking and all its subsidiary undertakings*" (EFRAG IG 2.34).

As subsidiaries are regularly not consolidated in the consolidated financial statements in accordance with IFRS for reasons of materiality, EFRAG IG 2.35 clarifies that, under certain circumstances, material impacts can also be triggered by these subsidiaries, which must be addressed in the sustainability report. In contrast to financial reporting, non-consolidated subsidiaries are therefore generally part of the ESRS reporting entity (see section 2.2).

The application of the unit theory in the group will require an analysis of the necessary consolidation measures: In particular, double counting in Scope 2 and 3 will have to be eliminated for greenhouse gas emissions from the upstream and downstream value chain. For the other information, it must at least be checked whether group relationships indicate against the simple addition of the group reporting packages. In contrast to financial reporting, the sustainability reporting of corporate groups must include information on the material impacts, risks and opportunities of subsidiaries arising from intragroup transactions.

In addition, the legislator has introduced the concept of *operational control* for environmental matters (see sections 2.3 to 2.6). Accordingly, for certain environmental topics, IROs must also be reported for companies, production facilities and assets as part of the company's own business operations for which only *operational control* exists (EFRAG IG 2.40). This is the case if the reporting entity has "*the ability to direct the operational activities and relationships of the entity, site, operation or asset".* Paragraph 41 of the EFRAG Value Chain Implementation Guidance states "*In alignment with the GHG Protocol, ESRS include the concept of operational control, [...]*". This implies that the extension was intended to harmonise the ESRS reporting obligation with the requirements of the GHG Protocol. It should be noted that the GHG Protocol proposes three alternative concepts for determining the reporting obligation – the equity method, financial control or operational control. The ESRS, on the other hand, do not allow the choice of one of these methods, but prescribe the mandatory application of the concept of financial control supplemented by that of operational control (see section 2.4).

The following table[5] illustrates the treatment of *impacts* according to ESRS E1 resulting from the company's financial investments, depending on their accounting treatment in the financial reporting.

5 Cf. EFRAG IG 2 Value Chain Implementation Guidance, FAQ 5: How are investees treated under ESRS E1, p. 31f.; https://www.efrag.org/sites/default/files/sites/webpublishing/SiteAssets/EFRAG%20IG%202%20Value%20Chain_final.pdf

	Common characteristic(s)	Accounting treatment[6]	Measuring impacts by metrics in E1 standard
Subsidiaries	Control (as defined in IFRS 10) – also referred to in this document as "financial control"	Include of 100% of assets, liabilities, equity, income, expenses and cash flows[7]	Fully included (scope of consolidation is the same as financial reporting)
Associates	Significant influence (as defined in IAS 28)	The financial investment is recognised as a single line item on balance sheet (cost adjusted post-acquisition changes in the investor's share of net assets). The investor's profit or loss and other comprehensive income include its share of the investee's profit or loss and other comprehensive income.	• operational control: GHG emissions to the extent of operational control (ESRS 1 paragraph 67) • associates that are actors in the value chain (purchases/sales with the investing undertaking): impacts connected to the undertaking's products and services through transactions; *and/or* • associates with other business relationships (i.e., investees) as for investments below.
Joint ventures	Joint control (as defined in IFRS 11) with rights to the net assets of the arrangement.	Same as for associates	Same scenario as for associates[8]
Joint operations	Joint control (as defined in IFRS 11) with rights to the assets and obligations for the liabilities relating to the arrangement.	Recognise its assets, liabilities, revenue, expenses, including any share from items held jointly	The assets/liabilities of the joint arrangement recognised on balance sheet by the reporting undertaking form part of own operations. In addition, where the reporting undertaking has operational control over its joint operators, these will be included under E1 paragraph 50(b).
Investments	All other investments (in the scope of IFRS 9)	Recognised at fair value, dividends in profit or loss, changes in fair value are recognised in profit or loss or in other comprehensive income.	No specific indications in ESRS E1 metrics on how to measure impacts connected with the undertaking through its investments (except for category 15 of GHG Protocol)

2.2 Non-material subsidiaries

In practice, when determining the scope of the consolidated sustainability report, the question arises as to how to deal with subsidiaries that are not fully consolidated in the consolidated financial statements due to their minor importance. The word according to ESRS 1 does not clarify whether all subsidiaries or only the subsidiaries included in the

6 Please note that this is a very simplified description of the financial reporting requirements (and may differ between IFRS *and* local GAAP standards used in European countries) and thus does not capture the nuances involved in classifying investments. For the actual definitions and accountant principles, please refer to the legal texts.

7 Except for an investment entity (as defined in IFRS 10) which shall measure an investment in a subsidiary at fair value through profit or loss.

8 Operational control can also apply to assets under joint control. The related GHG emissions then reflects the terms and conditions of the arrangement.

consolidated financial statements are relevant for the (consolidated) sustainability reporting. As subsidiaries are regularly not consolidated in the consolidated financial statements in accordance with IFRS for reasons of materiality, EFRAG IG 2.35 clarifies that, under certain circumstances, material impacts can also be triggered by these subsidiaries, which must be reflected in the sustainability report.[9]

ESRS 1.102 requires an unbiased evaluation of the group's material impacts, risks and opportunities in order to identify material sustainability aspects without a bias. As the concept of *impact materiality* is not the same as the concept of financial materiality, this evaluation must be carried out for *all subsidiaries*. It cannot be concluded from the financial immateriality of subsidiaries for financial reporting purposes that the subsidiary is equally immaterial in terms of the impact of its business activities from the perspective of sustainability reporting. At the very least, if the subsidiary's business activities have a material (environmental) impact, a deviation from the scope of consolidation for financial reporting purposes seems necessary (EFRAG IG 2.35; also IDW Statement on Financial Reporting: ESRS module pronouncement (100) (IDW RS FAB 100), module 2-1, section 4.). In our opinion, a reporting obligation would then have to be assumed insofar as the subsidiary is part of the group's value chain or other relevant business relationships exist.

If no relevant impacts, opportunities or risks are associated with the business activities of the financially immaterial subsidiary, a non-inclusion in the consolidated sustainability statement should be justifiable from the perspective of the ESRS.[10] The non-inclusion of subsidiaries should be justified and documented accordingly. This documentation should show that, on the one hand, the material IROs identified in the group have no material impact on the immaterial subsidiary from the perspective of double materiality and, on the other hand, no additional material impacts arise from the subsidiary that would need to be reported on in the sustainability report. In the interests of transparency regarding the procedure, the non-inclusion would have to be disclosed in accordance with ESRS 2 BP-1.

2.3 Expansion of the ESRS reporting scope through the concept of operational control

Individual ESRSs refer to the concept of operational control in order to identify situations in which information on environmental matters must also be presented for non-consolidated assets. Ultimately, this means that the ESRSs go beyond the boundaries of the general IFRS scope of consolidation when determining the limits of disclosure requirements for individual environmental impacts.

In addition to disclosures on the consolidated group (financially controlled entities, EFRAG IG 2.35), the ESRSs in ESRS E1 also require certain environmental information on joint ventures,

9 If a subsidiary is not included in the HGB consolidated financial statements due to Section 296 HGB, the explanations apply accordingly.

10 Cf. EFRAG, ESRS Implementation Q&A Platform January – May 2024, p.25; https://www.efrag.org/Assets/Download?assetUrl=/sites/webpublishing/SiteAssets/Explanations+January+-+May+2024+%28final+version%29.pdf

joint operations, investment entities and associates that are not financially controlled and therefore not consolidated, but over which the company has operational control.

This metric information must be collected and should be presented separately from the information concerning the group. In accordance with ESRS 1.57, the requirements of these thematic ESRSs take precedence as special requirements over the general requirements.

In order to fully comply with the legal requirements, it is therefore necessary to conduct a thorough analysis of the business relationships maintained by the group. For individual disclosures in accordance with the ESRS-E standards in the consolidated sustainability report, existing investments such as joint ventures, joint operations, investment companies and associates must therefore be analysed with regard to the existence of operational control and their role in the value chain and the results documented in a comprehensible manner.

In contrast, operational control is not relevant in the context of reporting on social information in accordance with ESRS S.[11] The definitions used in ESRS S1 (Own Workforce) and ESRS S2 (Workers in the Value Chain) are based on the contractual agreements between the employees and the reporting company. Similarly, ESRS S3 (Affected Communities) and ESRS S4 (Consumers and End Users) are based on the relationship between these stakeholders and the reporting entity.

2.4 When does operational control exist?

In Appendix II, Table 2 (Definitions in the ESRSs), operational control is defined as "a situation in which the (reporting) entity has the ability to direct the operating activities and relationships of the entity, site, operation or asset". For example, according to ESRS 1 AR 40 operational control exists when the entity (i.e. the parent company or a subsidiary) has the licence – or permission – to operate the assets of unconsolidated joint ventures, associates, non-significant subsidiaries and contractual arrangements.

The ESRSs do not yet specify detailed criteria for the existence of operational control. In terms of meaning and purpose, operational control may exist if the company can exert influence on the material matters identified under the ESRS-E, insofar as the ESRSs provide for the application of operational control. In our opinion, the company should therefore develop company-specific criteria that are suitable indicators for the existence of operational control.

We propose hereafter some criteria, which appear as suitable to us for assessing whether *operational control* exists, for example in the case of associated or joint companies, locations or other activities:

- *Contractual influence:* Does the group or a subsidiary have the ability to direct the operating activities of the entity or specific parts of it unilaterally (without the

11 Cf. EFRAG IG 2 Value Chain, para. 60f., p.18

consent of other shareholders) based on contractual arrangements or other agreements (e.g. joint venture agreement, side agreements)?

- *Legal attribution:* Does the group exercise rights or fulfil legal obligations for the unit (for example in connection with emissions trading schemes, the Supply Chain Due Diligence Act (*Lieferkettensorgfaltspflichtengesetz*) or other sustainability provisions)?
- *Operating policies:* Does the group have the ability to independently (without the consent of the other shareholders) establish and implement operating policies within the entity?

When assessing whether operational control exists, we see these three criteria as significantly important. If operational control is justified with the criterion of *operational guidelines*, the company should critically reflect on the extent of operational control associated with this. If virtually all operationally relevant guidelines can be introduced unilaterally (for example, in the case of a lease agreement in which the lessee is unilaterally responsible for the operation of the leased property), operational control will regularly exist; other than in cases, where operational instructions can only be issued individually or selectively. The company should then assess the criterion restrictively during the evaluation, look for additional indicators, justify and document this assessment in a comprehensible manner.

In our opinion, additional indicators for the existence of operational control could be the following:

1. *Percentage of shareholdings:* Does the percentage share of equity enable the group to influence the operating activities of the unit (without approval of the other shareholders)?
2. *Personnel overlap: Are there any* overlaps between the group and the unit in key management positions (e.g. management, supervisory boards, top management level)?
3. *Significant overlaps in the portfolio of products and services offered:* Does the entity's decisions regarding its own product and service offering depend significantly on the group (for example, production planning, manufacturing process, service specifications)
4. *Organisational integration:* Is the unit *de facto* integrated into the business processes and monitoring of the reporting company?
5. *Expertise:* If certain business processes are supplied to the joint venture by the reporting company and the expertise for maintenance, further development etc. is provided by the company, there will be operational control in this respect.

2.5 Consequences of operational control based on the example of the ESRS E standards

The following overview shows specific cases for the expansion of the reporting scope due to operational control in the ESRS E standards:

ESRS E1

Emissions data

Disclosure Requirement E1-6 – Gross Scopes 1, 2, 3 and Total GHG emissions

50. For Scope 1 and Scope 2 emissions disclosed as required by paragraphs 44 (a) and (b) the undertaking shall disaggregate the information, separately disclosing emissions from:

(a) the consolidated accounting group (the parent and subsidiaries); and

(b) investees such as associates, joint ventures, or unconsolidated subsidiaries that are not fully consolidated in the financial statements of the consolidated accounting group, as well as contractual arrangements that are joint arrangements not structured through an entity […], **for which it has operational control.**

AR46. (h) […] Scope 3 categories should […] include: […] ii. indirect Scope 3 GHG emissions from associates, joint ventures, and unconsolidated subsidiaries **for which the undertaking has the ability to control the operational activities and relationships (i.e., operational control)**

ESRS E2

Pollution data

Disclosure Requirement E2-4 – Pollution of air, water and soil

28. The undertaking shall disclose the amounts of:

(a) each pollutant listed in Annex II of Regulation (EC) No 166/2006 of the European Parliament and of the Council64 (European Pollutant Release and Transfer Register "E-PRTR Regulation")emitted to air, water and soil, with the exception of emissions of GHGs which are disclosed in accordance with ESRS E1 Climate Change;

(b) microplastics generated or used by the undertaking

29. The amounts referred in paragraph 28 **shall be consolidated amounts including the emissions from those facilities over which the undertaking has financial control and those over which it has operational control**. The consolidation shall include only the emissions from facilities for which the applicable threshold value specified in Annex II of Regulation (EC) No 166/2006 is exceeded.

ESRS E4

Biodiversity data

Disclosure Requirement ESRS E4 SBM 3 – Material impacts, risks and opportunities and their interaction with strategy and business model

16. The undertaking shall disclose:

(a) a list of material sites in its own operations, **including sites under its operational control**, based on the results of paragraph 17(a). The undertaking shall disclose these locations by:

i. specifying the activities negatively affecting biodiversity sensitive areas;

ii. providing a breakdown of sites according to the impacts and dependencies identified, and to the ecological status of the areas (with reference to the specific ecosystem baseline level) where they are located; and

iii. specifying the biodiversity-sensitive areas impacted, for users to be able to determine the location and the responsible competent authority with regards to the activities specified in paragraph 16(a) i.

The differentiated reporting according to ESRS E1-6 below may illustrate this. In accordance with ESRS 1-6, the reporting company must disclose the total of its gross greenhouse gas emissions and allocate it to Scope 1, Scope 2 and Scope 3 categories.

- *If operational control* exists, the Scope 1 and Scope 2 emissions of joint ventures, joint operations, investment companies[12] and associated companies must be reported at 100 per cent for the period in which operational control exists, regardless of the percentage of the existing investment. If operational control is only affirmed for parts of the business activity, the issues are only to be disclosed in full for these parts.

  In this context, ESRS E1-6 50.b requires Scope 1 and Scope 2 emissions of entities not fully consolidated but with existing operational *control* to be disclosed *separately* from the Scope 1 and Scope 2 issues of the basis of consolidation used for financial reporting (i.e. parent company and subsidiaries). Furthermore, if operational control exists for Scope 3 categories in accordance with AR 46 (h) (ii), the indirect Scope 3 emissions of these associates, joint ventures and non-consolidated subsidiaries must also be respected.

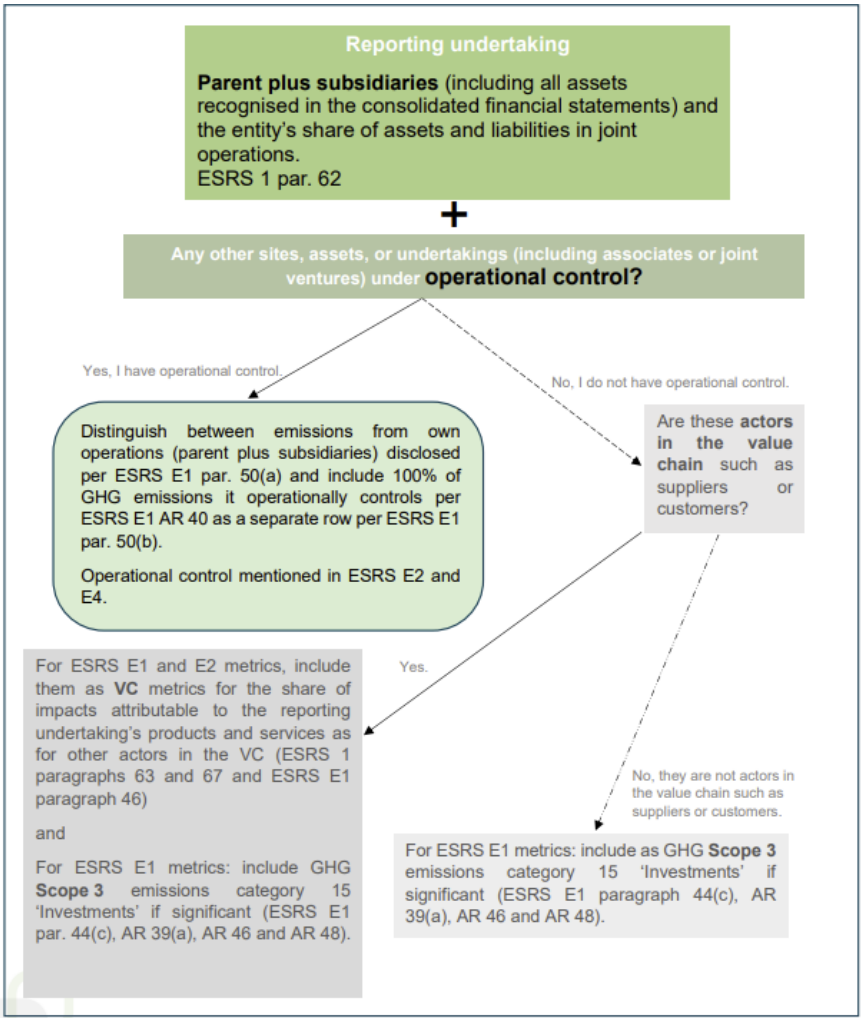
- However, if there is *no* operational *control,* the issues are not to be considered as Scope 1 or Scope 2 issues (in addition to the issues of the parent company and the consolidated subsidiaries), but only as part of Scope 3 issues. In this case, the reporting company must assess whether the non-operationally controlled joint ventures, joint operations, investment companies and associates are part of the

12 The term *investment entity is* not defined in detail in the ESRS. According to ESRS E1-6 (46.), AR 40 and AR 46 (h)(ii), such companies are to be understood as non-consolidated subsidiaries.

upstream or downstream value chain. If this is the case, the proportionate emissions associated with the reporting company's products or services must be reported under the corresponding Scope 3 emissions categories. Otherwise, it is assumed that the investments are held as financial investments. The issues are then allocated to the Scope 3.15 'Investments' category for reporting purposes if they are significant.

When analysing the upstream and downstream value chain, the treatment of greenhouse gas emissions of not fully consolidated investments should also apply to units, other assets and locations if operational control exists over their business activities, according to EFRAG (EFRAG IG 2 VCIG 49).

The following flow chart from EFRAG IG 2 illustrates this relationship:



As already mentioned, ESRS E-1 therefore reaches beyond the general IFRS scope of consolidation as regards the disclosure requirements for environmental impacts on Scope 1 and Scope 2 emissions by extending these to include the disclosure of (non-financially but) operationally controlled Scope 1 emissions. At the same time, ESRS E-1 does not allow any limitation within the IFRS scope of consolidation if emissions are financially but not operationally controlled or cannot be directly influenced (see example in section 1.6).

In this context, it should be mentioned that the GHG Protocol[13] recommends a clear separation of the concepts of financial and operational control and their alternative application when determining the scope of consolidation in connection with the disclosure of GHG emissions. Consequently, the scope of consolidation should be determined on the basis of either financial or operational control; the choice of consolidation method[15] depending on the business model and individual circumstances at the discretion of the reporting company.[16] Once the scope of consolidation has been determined, the GHG Protocol provides for the determination of (further) operational boundaries in a second step in order to categorise the emissions associated with the scope of consolidation into Scope 1, 2 or 3.

With regard to ESRS E-1, this results in the following differences:

- The concepts of financial and operational control are alternatives in the GHG protocol, while ESRS E-1 is based on the concept of financial control, supplemented if necessary by information due to the existence of only operational control.
- The GHG Protocol also does not assume that all emissions associated with the entities included in the scope of consolidation must automatically qualify as Scope 1 emissions or can be directly influenced. Whether emissions within the scope of consolidation are to be categorised as Scope 1, 2 or 3 should depend much more on further operational boundaries to be determined. ESRS E-1, on the other hand, does not assume that further differences between Scope 1, 2 and 3 emissions should be made within the scope of consolidation.

Due to these differences, the emissions to be calculated according to ESRS E1-6 (50.) are not necessarily comparable with the results calculated according to the GHG Protocol.[17] This could also result in calculations deviating from the ISSB standards, as the ISSB standards are based on the requirements of the GHG Protocol.

13 https://ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf
14 GHG Protocol, p. 17: "When using the control approach to consolidate GHG emissions, companies shall choose between either the operational control or financial control criteria."
15 The third consolidation method recommended in the GHG Protocol (equity method) is not described in detail in this paper.
16 GHG Protocol, p. 20: "The GHG Protocol Corporate Standard makes no recommendation as to whether voluntary public GHG emissions reporting should be based on the equity share or any of the two control approaches but encourages companies to account for their emissions applying the equity share and a control approach separately. Companies need to decide on the approach best suited to their business activities and GHG accounting and reporting requirements."
17 EFRAG IG 2, para. 54 – 57 on "Comparability of ESRS E1 and the GHG Protocol.

2.6 Practical examples: Implementation challenges

The following examples are indicative statements that do not allow any direct conclusions to be drawn from other circumstances, as the assessment and documentation of the company-specific individual case always requires an analysis of the facts and circumstances of the individual case.

When assessing whether operational control exists, a company should, in our opinion, consider industry-specific characteristics as well as the type of contract on which the business relationship may be based.

2.6.1 Questions arising from the example of an industrial company

In our first example, we present selected issues relating to the definition of the ESRS reporting entity using an example from the tourism industry. The vertically integrated tourism company bundles tour operators, airlines and hotel activities under one roof. In addition to owning their own aircraft, the fully consolidated airlines and tour organisers in the group also use aircraft leasing. In the hotel activities segment, there are investments in joint ventures and associates that are recognised at equity in the financial reporting in accordance with IFRS. These (not fully consolidated) investments were categorised as players in the value chain and are not held as financial investments.

The group expects to disclose environmental, social and governance data, including information on CO_2 emissions, pollution and biodiversity. The collection and processing of this data requires the development of a comprehensive data infrastructure.

The starting point for defining the CSRD or ESRS reporting scope is the reporting parent company and the fully consolidated subsidiaries. The example focuses on the question in which cases this financially controlled reporting entity should follow the reporting requirements of ESRS-E on emissions, pollution and biodiversity using the concept of operational control.

Airlines & other flight activities

As the airlines are fully consolidated subsidiaries, they have financial control over their own aircraft and over aircraft leased as part of *sale and leaseback transactions.*

Right-of-use assets are recognised for leased aircraft in accordance with IFRS 16. According to the view expressed here, a right of use *per se* cannot cause any emissions of its own; the outcome of the current discussion at EFRAG level remains to be seen. According to the concept of financial control, no emissions are therefore to be recognised for these leased aircraft in accordance with the ESRS. This interim result is not convincing. The reporting entity is therefore examining whether the scope of reporting should be expanded to include the emissions of these leased aircraft based on operational control. The leases would have to be classified as *operating leases* under the alternative accounting standards IAS 17, US GAAP or HGB. The lease agreements give the lessee extensive rights to operate the leased aircraft.

According to the regulatory requirements for emissions trading, the airlines are also deemed to be the operator. The airlines are legally obliged to offset their own emissions by means of CO_2 certificates. The criteria for operational influence are met.

By contrast, there is no operational control if the airlines or tour operators hire individual flights from external airlines or purchase seat allotments or individual seats. In these cases, the flights are operated by the external airline under its own flight number. From the perspective of the reporting company group, the emissions in connection with these flight services are regularly Scope 3 emissions and must be recognised and reported on a pro rata basis.

As an interim result, the group must present the total emissions in a differentiated manner. Dividing the emissions of its own aircraft fleet into financially controlled and operationally controlled aircraft causes additional administrative work, while negligible information is gained for the company and the users of the sustainability report.

Hotel activities

In addition to the hotels owned and leased by the subsidiaries and joint ventures and associated companies, the group operates third-party hotels under management agreements. There are also franchise agreements, brand licence agreements and hotel concept agreements with external hoteliers. In all cases, there are also hotel purchasing agreements between the tour operators and the group's internal and external partners, which are therefore regularly categorised as players in the value chain.

Based on the financial scope of consolidation, the group analyses for which hotels owned by joint ventures or associated companies and by owners outside the group the concept of operational control requires an expansion of the reporting scope.

In the example, the corporate group decides to cluster the business relationships between the parties according to contract types:

- The hotels *owned by* the fully consolidated subsidiaries are under financial control.
- In case of *lease agreements* of consolidated subsidiaries, the company assumes operational control. Under a lease agreement, the lessee rents the hotel property (i.e. a right of use is recognised in accordance with IFRS 16) and undertakes to the legal owner to operate a hotel there. The lessee itself is the owner of the hotel business. As operator of the hotel, they alone are responsible for all operational decisions and can change or introduce new operational processes. Operational control is therefore based on the two criteria of contractual influence and the power to issue operational guidelines.
- In the case of existing *hotel management or franchise agreements* and *hotel purchase agreements* (e.g. purchase of hotel contingents) between fully consolidated subsidiaries and the hotel owners, the reporting company examines the specific individual cases on the basis of the company-specific characteristics:

- *Hotel management contract:* The hotel management company is contractually responsible for the operation of a third-party hotel and makes operational decisions unilaterally – with the exception of the decisions reserved for the owner under the contract regarding material matters (e.g. budget, investments, borrowing). In EFRAG's opinion, operational control does not presume that the operator can make all decisions.[18] Depending on the evaluation of the individual case based on the company-specific criteria, operational control may exist on a contractual basis.
- *Franchise agreement:* The franchisee (external party) is a third-party hotel owner who manages the hotel in accordance with the contractual requirements of the consolidated subsidiary (franchisor). It seems appropriate to analyse the individual case on the basis of company-specific criteria, taking into account industry-specific features. In the case of typical franchise agreements, the extent of influence on those operational processes of the hotel (the franchisee) that are associated with environmental impacts is likely to be questionable on a regular basis.
- *Tourist purchasing contract:* As a tourism service provider, the hotel owner provides the contractually agreed services for the fully consolidated tour operators. In such contracts, the hotel owner will normally have operational control, as they provides the service to the traveller either legally themself or as an agent of a package tour organiser. If it is an intragroup supply relationship, we nevertheless believe emissions to be reported in Scope 1 or Scope 2, as financial control exists over the fully consolidated hotel company. In our opinion, the entrepreneur does not have to report the emissions additionally as Scope 3 emissions, as this would result in double counting of the emissions.

The situations outlined above would have to be assessed differently if the hotel owner, the lessee or the hotel management company is a non-fully consolidated joint venture, an associated company or an external party. In these alternative cases, the fictitious group of companies would neither have financial control due to the ownership structure. Nor could it have its own operational control based on the contracts underlying the relationships, in which – from a group perspective – only external parties would be involved.

In contrast, the example company would still have to collect and report in Scope 3 the proportionate emissions of these actors in the value chain that are associated with the provision of flight and hotel services to tour operators in the company group.

As a result, the differentiated reporting required by the ESRS requires a detailed analysis of the interplay between the scope of consolidation in the balance sheet and the relationships with the players in the value chain, including investments that are not fully consolidated.

18 See GHG Protocol, p. 18; reference from EFRAG IG 2 Value Chain, para. 44, p. 14.

2.6.2 Questions arising from the example of an insurance company

Two examples of situations that may arise in conjunction with the implementation of ESRS E-1 at insurance groups are presented below. The first example addresses the situation in which the financially controlled reporting scope for reporting on emissions (and water consumption) is to be expanded via the concept of operational control. The second example illustrates the problem that the financially (and possibly operationally) controlled reporting scope cannot be limited at the same time due to potential operational boundaries/lack of direct influence and therefore certain emissions predefined as Scope 1 by ESRS E1-6 would qualify as Scope 3 emissions.

a) No financial control, but operational control

   For insurance companies, a case of operational control but not of financial control typically occurs in joint venture constellations. For example, the insurance company has operational control over a joint venture in which it holds less than 50 per cent of the shares and therefore has no financial control but operational control to the extent that it holds the operational asset management mandate over the joint venture. Based on contractual agreements, the insurance company therefore has direct influence on the emissions and water consumption of the joint venture, i.e. operational control. In this case, the direct emissions of the joint venture would have to be qualified as Scope 1 emissions of the insurance company and reported accordingly (ESRS E1-6).

b) Financial control, but no operational control or direct influence (operational limits)

   At the same time, issues arise for large insurance companies if certain assets/investments are fully consolidated but only held for investment purposes while fully leased to third parties. In this case, although there is financial and possibly also operational control, the existence of direct influence could at least partially be questioned due to operational limits since the real emissions or water consumption can only be predefined or directly influenced by the tenant to a limited extent. For example, whereas the consumption of general electricity (e.g. hallways) can directly be influenced by the landlord, it is difficult for the tenant to directly control water consumption. Applying ESRS E1-6, all emissions from the rental property would have to be reported as Scope 1 emissions without restriction due to financial control. However, if the GHG Protocol and the associated limitation of the scope of consolidation according to operational boundaries were applied, emissions (even from fully consolidated entities) would only be reported as Scope 1 GHG emissions to the extent that they were within the landlord's direct control. In other cases, these would be reported as Scope 3 issues.

As a result, the differentiated reporting according to the ESRS requires a detailed analysis of the interplay between the scope of consolidation for accounting purposes and the relationships with the players in the value chain, including investments that are not fully consolidated.

3 Definitions of terms

3.1 Employees

The employees of an organisation are a central concept for the social reporting standards of the ESRS but are not used unambiguously in the German translation. In ESRS Standard S1 – Own Workforce, the term "employees" is introduced in paragraph 4: "This standard covers an undertaking's own workforce, which is understood to include both people who are in an employment relationship with the undertaking ("employees") and non-employees [...]". There would therefore be "salaried" and "non-salaried employees". However, the term "employees" cannot be understood as an umbrella term for these two groups: In the definitions (Annex 2, Table 2), an employee is defined more narrowly as "An individual who is in an employment relationship with the undertaking according to national law or practice", i.e. all persons who perform work as employees, owners or in other fixed relationships, for example from a civil servant relationship.

In contrast, the original English text delineates the parts of the workforce that are "*non-employed*", which was translated into German as "nicht angestellte Beschäftigte". This subgroup "*non-employed*" is further explained in ESRS S1, AR 3 by means of examples and includes self-employed individuals who are commissioned by the company to perform work (in contrast to work orders) (in particular so-called day labourers), as well as persons who perform "employment activities", i.e. agency and temporary workers.

When working with the German version, the term employees is therefore only to be understood in the sense of "*employees".* The extended group is only meant when explicitly referring to "non-employees" or the "own workforce" as a whole.

3.2 CapEx/OpEx

3.2.1 The definition of *operational expenditure* and *capital expenditure* in accordance with ESRS

The terms CapEx and OpEx are used several times in the ESRS. In principle, they refer to *operational expenditures* and *capital expenditures* respectively (ESRS 2.69).

The ESRS do not appear to require a clear delineation as to when CapEx or OpEx in the narrower sense (= EU taxonomy or key CapEx and OpEx performance indicators) represent the reference point and when "significant" CapEx and/or OpEx in the broader sense (e.g. according to an adjusted company definition) are reported. Both terms are not defined in the context of the ESRS.

The fact that the ESRS refer to the EU CapEx/OpEx taxonomy as the most important CapEx and OpEx performance indicator makes it seem linguistically possible that there are also

other, less significant CapEx and OpEx performance indicators according to the ESRS's understanding of the term, which deviate from the definition of the EU taxonomy.

The decisive factor is that it is evident whether the reference point is the narrow definition of the EU taxonomy or whether an extended understanding of the term is used in the specific report.

The defined group boundaries may result in differences in the reporting of CapEx or OpEx performance indicators, provided that the reference point is not the narrow definition of the EU taxonomy. It should also be noted that companies _ must use their own accounting methods and accounting standards as a basis for categorisation. As a result, there may be differences between IFRS and HGB accountants, for example.

The wording *"The disclosed CapEx and OpEx amounts shall be the additions made to both tangible and intangible assets during the current financial year"* indicates that, as stated in the EU taxonomy, capital expenditure includes

- Additions to tangible (IAS 16, IAS 40, IAS 41, IFRS 16) and intangible (IAS 38) assets excl. valuation changes such as revaluations, impairments, depreciation and amortisation and changes in fair value; and
- Additions from business combinations (IFRS 3)
- Additions to right-of-use assets recognised in accordance with IFRS 16

At this point, it should be noted that goodwill is explicitly not categorised as CapEx in accordance with the Taxonomy Regulation.

It should be noted that "only" direct expenses may be recognised as *operating expenses (OpEx)* under the EU taxonomy (e.g. research and development expenses, building renovation measures, expenses for short-term leasing relationships; as well as maintenance and repair costs and all other directly attributable costs that are relevant for the ongoing maintenance and preservation of the functionality of fixed assets). It remains questionable whether, in the case of the extended CapEx definition of the ESRS, operating expenses that also include indirect costs may be included in investment plans – in contrast to the EU taxonomy.

3.2.2 Conceptual reference points in selected ESRS disclosures

ESRS 2.69

Where the implementation of an action plan requires significant operational expenditures (OpEx) and/or capital expenditure (CapEx) the undertaking shall

a) describe the type of current and future financial and other resources allocated to the action plan, including if applicable, the relevant terms of sustainable financial instruments, such as green bonds, social bonds and green loans, the environmental or social objectives, and whether the ability to implement the actions or action plan

depends on specific preconditions, e.g. granting of financial support or public policy and market developments;

b) provide the amount of current financial resources and explain how they relate to the most relevant amounts presented in the financial statements; and

c) provide the amount of future financial resources.

ESRS E1-3. AR20

When disclosing the information on resources in accordance with paragraph 29(c), the company shall only disclose the significant OpEx and CapEx amounts necessary for the implementation of the measures, as the purpose of this information is not to reconcile the disclosed amounts with the financial statements, but to demonstrate the credibility of its operations. The CapEx and OpEx amounts disclosed are the tangible and intangible assets added in the current financial year and the new assets planned for future periods during the implementation of the measures. The amounts stated are only the additional financial investments that contribute directly to achieving the company's objectives.

ESRS E1-3.AR22

The OpEx and CapEx amounts required to implement the measures specified in accordance with paragraph 29(c) [Note: Measures and resources related to the climate strategies] shall be consistent with the key performance indicators (key CapEx and OpEx performance indicators) and, where applicable, with the CapEx plan required by Commission Delegated Regulation (EU) 2021/2178. The company shall explain any differences between the significant OpEx and CapEx amounts disclosed in accordance with this standard and the key performance indicators disclosed in accordance with the Taxonomy Regulation (EU) 2021/2178, for example due to the disclosure of ineligible economic activities as defined in that Regulation. The entity may structure its activities by economic activity in order to compare its OpEx and CapEx and, where applicable, its OpEx and/or CapEx plans with its key performance indicators in accordance with the taxonomy.

3.3 Climate transition plan

"Transition plans" are an important element of the ESRS, in which the goals and measures of companies are checked against recognised development paths. They are required both in E1 for climate protection and in E4 for the protection of biodiversity. With the reporting requirement set out in E1-1, companies are obliged to present their climate transition efforts with regard to their 1.5-degree conformity as well as their strategic and financial embedding.

One of the key elements of climate transition plans is the use of scientifically based climate neutrality scenarios as benchmarks (e.g. Science Based Targets Initiative, SBTi, or Intergovernmental Panel on Climate Change, IPCC). However, there is a wide range of scenarios and methodological differences and not all scenarios for climate neutrality by 2050 are compatible with the international 1.5-degree target. Therefore, detailed sectoral and

regional scenarios and the use of transition indicators can improve the comparability of transition plans.

For the financial risk assessment, the discrepancy between the time horizons of the climate scenarios (several decades) and the financial risk assessment (a few years) is an additional challenge.

ESRS E1-1 requires companies to provide specific information on ten points, which can be grouped as follows:

1.5-degree conformity

1. Are the company's climate targets to be provided at a later stage in accordance with E1-4 compatible with a recognised and, if available, sector-specific reduction pathway for the 1.5-degree target?
2. Is the company exempt in whole or in part from the Paris-aligned EU reference values according to the Delegated Regulation "EU Climate Transition Benchmarks and EU Paris-aligned Benchmarks" ((EU) 2020/1818, Article 12.1 (d) to (g), and Article 12.2))?
3. To what extent has progress already been made on the transition plan?

Strategy

1. What starting points for avoiding emissions (so-called decarbonisation levers) are available for the conversion of the company's business model and which of the most important measures are planned by the company?
2. How is the transition plan embedded in the company's business strategy and financial planning?
3. Has the transition plan been approved by the company's executive bodies (Management Board, Supervisory Board)?

Financial resources

1. How much spending is available for investments and measures to implement the transition plan in the company? How do these funds relate to the provided taxonomy-compliant CapEx?
2. How many emissions are still being emitted from existing assets and those firmly planned for the next five years over their working life ("locked-in" emissions)? To what extent do these emissions jeopardise the company's reduction plans?
3. What (CapEx/OpEx) plans exist for the taxonomy goals climate change mitigation and adaptation?

4. What investments were made in economic activities in the coal, oil and gas sectors in the reporting year?

Companies that do not have a transition plan must indicate this and must make a statement as to whether and by when they intend to prepare such a plan. If a company can disclose a transition plan with the above-mentioned elements, this has an exempting effect on selected disclosures of ESRS E1-2 and E1-4.

The elements required by EFRAG also partly reflect the six basic principles recommended by CDP: accountability, coherence and foresight are named in the strategy points. However, timeliness, quantity and completeness are added:

- *Time-bound and quantitative:* The plan's KPIs are quantifiable and are defined for specific time periods.
- *Flexible and responsive:* The plan is regularly reviewed and updated, with a defined mechanism in place for stakeholder feedback (for example, shareholders at AGMs).
- *Complete:* The plan covers the entire company and its value chain, i.e. all exceptions to the plan must not be material to the company and/or its impact on the natural environment (whereby the principle of double materiality applies to the disclosure of exceptions).

Climate transition plans help companies not only to structure their strategic planning (non-regulatory planning) on the path to climate neutrality, but also to recognise and address any transition risks (regulatory planning) at an early stage along the way. With climate transition plans, companies generally set targets for reducing emissions, commit to monitoring their progress with climate protection measures and reduce their exposure to climate-related risks.

Current challenges for the effectiveness of climate transition plans result for companies from the lack of standardisation and therefore comparability, insufficient ambition levels and different time horizons.

3.4 Consumer/end user

ESRS S4 addresses the impacts, risks and opportunities for *consumers and end users* of the products or services sold by the user. The terms as such are defined in Annex II of Delegated Regulation (2023) 5303, Table 2, "Terms defined in the ESRS", as follows

- Consumer: Individuals who acquire, consume or use goods and services for personal use, either for themselves or for others, and not for resale, commercial or trade, business, craft or profession purposes.
- End users: Individuals who ultimately use or are intended to ultimately use a particular product or service.

Similar to the topic-related ESRSs, the reporting obligations associated with ESRS S4 are largely characterised by the assessment of double materiality. In line with the application requirements, ESRS S4 places a particular focus on human rights violations in the areas of information, safety and health and discrimination in the topics and sub-topics. ESRS S4 is strongly orientated towards the guidelines of the Global Reporting Initiative (GRI). Companies that have already prepared sustainability statements in accordance with GRI should therefore have no major difficulties in applying ESRS S4.

It is important to note that ESRS S4 explicitly targets customers who are both consumers and end users. Other customers (e.g. B2B) are dealt with in the relevant other standards through information about the downstream value chain.

3.5 Value chain

The *ESRS* defines the value chain as follows:

Value chain	The full range of activities, resources and relationships related to the undertaking's ***business model*** and the external environment in which it operates.
	A ***value chain*** encompasses the activities, resources and relationships the undertaking uses and relies on to create its products or services from conception to delivery, consumption and end-of- life. Relevant activities, resources and relationships include: i. those in the undertaking's own operations, such as human resources; ii. those along its supply, marketing and distribution channels, such as materials and service sourcing and product and service sale and delivery; and iii. the financing, geographical, geopolitical and regulatory environments in which the undertaking operates. ***Value chain*** includes ***actors*** upstream and downstream from the undertaking. ***Actors*** upstream from the undertaking (e.g., ***suppliers***) provide products or services that are used in the development of the undertaking's products or services. Entities downstream from the undertaking (e.g., distributors, customers) receive products or services from the undertaking. ESRS use the term "***value chain***" in the singular, although it is recognised that undertakings may have multiple ***value chains***.

- A company's value chain comprises the activities, resources and relationships that the company uses and relies on to create its products or services, from conception to delivery, consumption and end of life.

  The value chain includes not only the supply chain, but also key players upstream and downstream of the company. An upstream actor offers products or services that are used in the development of the company's own products or services (e.g. suppliers). Companies that are downstream receive products or services from the company (e.g. distributors, customers).

EFRAG Implementation Guidance 2 "Value Chain"[19] deals with the company's value chain in upstream and downstream activities and not its own operational processes in order to clarify user questions. It includes, among others:

- The company's sustainability statement should contain information on all IROs, including those that arise or may arise related to the company's business relationships in the upstream and downstream value chain. Business relationships are not limited to direct contractual relationships.
- The company is not required to include value chain information in all disclosures, but only if it is linked to material IROs beyond its own operations due to business relationships and if this is specifically required by the disclosure obligation.
- Therefore, the materiality assessment should cover the identification of material IROs in the value chain, focussing on where geographies, activities/sectors, operations, suppliers, customers, other relationships, etc. are likely to occur in the value chain.
- Topic-specific standards require disclosures on policies, objectives and measures for material topics. In particular, they require either the disclosure of such or a statement about their non-existence. To the extent that these policies, measures and targets affect value chain actors, the disclosure for material topics should include information on how they address material IROs in the upstream and downstream value chain.
- Topic-specific standards only require value chain information for some indicators. However, if the entity considers that a material IRO in the value chain is not sufficiently covered by the requirements in the ESRSs, it should include additional entity-specific disclosures, including key performance indicators, if such information is required to enable users to understand the entity's material impacts, risks or opportunities.
- If, after making reasonable efforts, the company cannot collect primary value chain information from stakeholders in its value chain for the materiality assessment or to prepare its disclosures of material IROs, it should estimate the missing information. These estimates must nevertheless meet the requirements for truthful reporting (ESRS 1.QC5-QC9).

19 https://www.efrag.org/sites/default/files/sites/webpublishing/SiteAssets/EFRAG%20IG%202%20Value%20Chain_final.pdf

4 Internal control system for CSRD/ESRS sustainability reporting

4.1 Legal framework and requirements

4.1.1 Current legal framework and frameworks

The Corporate Sustainability Reporting Directive (CSRD) came into force on 5 January 2023 and will be transposed into German law by the CSRD Implementation Act (CSRD-UmsG). According to CSRD, a growing number of companies will be obliged in the future – starting from the reporting period 2024 – to include a sustainability report in the management report based on the ESRS. Compared to the current reporting requirements, this sustainability report will include significantly more comprehensive information on environmental, social and human rights aspects as well as governance aspects (so-called ESG data).

The scope and complexity of the new regulatory requirements require the systematic collection, evaluation and disclosure of qualitative and quantitative ESG information. To ensure the completeness and accuracy of ESG data and the underlying processes, the establishment of an appropriate and effective ICS (for sustainability reporting) for the collection, evaluation and disclosure of ESG data is not only meaningful, but also necessary.

The legal requirements for the ICS were revised by the Financial Market Integrity Strengthening Act (FISG) on 1 July 2021 with the introduction of § 91 (3) AktG. According to this, the "management board of a listed company is to put in place an internal control system and risk management system that is suitable and effective in light of the scope of the business activities pursued by the enterprise and in light of its risk situation." Recommendation A.3 of the German Corporate Governance Code specifies that the ICS should also cover sustainability-related objectives, unless they are already required by law.

The provisions of an ICS are appropriate if, in accordance with the ICS principles applied, they are suitable for achieving the ICS objectives for preparing a sustainability report with reasonable assurance. An ICS is effective if the requirements are complied with in the ongoing business processes by those affected in accordance with their responsibilities during the specified period.[20]

The increased requirements resulting from CSRD reporting correspond to the new disclosure requirements of ESRS 2.34-36. Among other things, the sustainability report must disclose the scope, main features and components of internal controls in relation to sustainability reporting and how the results of these internal controls are reported to the management and supervisory bodies. In accordance with § 289h and § 315f HGB in the version of the draft bill

20 Cf. IDW Praxishinweis: Ausgestaltung und Prüfung des internen Kontrollsystems zur Aufstellung eines Nachhaltigkeitsberichts unter Beachtung des IDW PS 982 (IDW Praxishinweis 4/2023), margin no. 35 and 36 with further notes.

of the CSRD-UmsG, the legal representatives of domestic issuers must affirm in writing in the management report that the sustainability report complies with European regulations including the ESRS requirements. § 107 (3) sentence 2 AktG in the version of the draft bill of the CSRD-UmsG stipulates that the Audit Committee must deal with the sustainability reporting process and the effectiveness of the ICS.

The establishment of an ICS for sustainability reporting is not specifically regulated by a standard setter, at least in the German legal system. However, there are various frameworks that have proven to be best practice and can therefore be used as a starting point. These include, in particular, the audit standard 982 of the Institute of Public Auditors in Germany and the associated Praxishinweis 04/2023, as well as the principles based COSO Supplemental Guidance ICSR (Internal Control over Sustainability Reporting). The latter builds on the COSO framework for the financial ICS and clarifies that the basic principles of an ICS for financial and sustainability reporting can be applied analogously. Based on the ICSR, various core elements are presented below.

4.1.2 Resulting requirements & challenges

Internal control systems are an integral part of corporate governance. Their design and maturity vary depending on company size, capital market orientation and complexity.

Regardless of the focus on financial or sustainability issues, an ICS pursues the same intention: significant errors or irregularities within a process should at best be prevented or, alternatively, be detected and mitigated promptly. With regard to external sustainability reporting in the context of the CSRD, such controls include the prevention and detection of material errors and/or irregularities in relation to the completeness, accuracy and timely provision of relevant sustainability information to be reported in the underlying processes.

The assessment and understanding of the accounting-related ICS has already been an important step in the statutory audit of financial reporting for risk assessment and identification, as the auditor determines the audit strategy and associated audit procedures based on the understanding of the accounting-related ICS. In contrast to the traditional and established area of the financial ICS, there are currently no mature and well-established structures in the ICS for sustainability reporting. To ensure the completeness and accuracy of sustainability reporting, companies will have to strive for a similar degree of formalisation for the ICS for sustainability reporting.

For many companies, meeting the requirements of the expanded sustainability reporting will lead to significantly increasing requirements on the scope and level of formalization of the ICS, necessitate organisational adjustments and require (considerable) financial and human expenditures. In the medium term, many companies will (have to) take further steps in the maturity level of the ICS for sustainability reporting. In a recent study by Deutsches Aktieninstitut, for example, around three quarters of the companies surveyed stated that

they are taking measures regarding internal processes or audit procedures to support the implementation of ESG objectives.[21]

The existing processes and structures for financial reporting should be utilised as far as possible for the ICS for sustainability reporting. The risk assessment and the implementation of internal control activities, including their monitoring as a core task of internal auditing, are iterative processes to be carried out annually. An appropriate and effective ICS should be scalable and flexible in accordance with the company's business activities and risk situation in order to be able to adapt to changes within and outside the company as well as to regulatory changes. This may require the risk assessment to be updated, existing controls to be changed or additional controls to be implemented. Such changes may also mean that previously identified risks may no longer be in focus, so that control measures can be rationalised to eliminate those controls that may no longer be relevant.

Companies and their business activities are changing continuously. This means that the appropriateness and effectiveness of the ICS are a permanent challenge, whereby optimisation potential can be realised through improved integration and automation of processes and data flows as well as the increased use of IT systems.

4.2 Key questions

4.2.1 Key questions for the ICS for the sustainability reporting process

In order for the ICS to prevent material errors or irregularities within sustainability reporting or, alternatively, to detect and mitigate them promptly, the following fundamental factors of the sustainability reporting process should be accompanied by organisational precautions, systems and control measures:

21 "Companies & ESG", Deutsches Aktieninstitut (ed.) in cooperation with Hengeler Mueller, June 2024, p. 22. https://www.dai.de/en/detail/companies-esg-transformation-or-just-reporting

Steps	Key questions
Governance	Who is responsible for sustainability reporting in the company at Management Board level and at the level of the specialist department? How is the Audit Committee involved in monitoring sustainability reporting and the associated ICS?
Design – Organisational structure	How are systems, processes and responsibilities established within the company to fulfil the sustainability reporting demands of management, stakeholders and regulators?
Data collection	How is the data relevant to sustainability reporting collected accurately and in a timely manner?
Necessary estimates	How are necessary estimates made in a comprehensive and truthful manner?
Recording the data	How is the original data or source data recorded and documented to enable the traceability of the data?
Calculation of KPIs	How is the raw data or source data used to calculate the relevant KPIs?
Compilation of the data	How is the necessary data compiled and prepared for reporting?
Finalisation of sustainability reporting	How is the information for the sustainability report and the sustainability reporting as such reviewed, validated and approved for completeness and accuracy?

The following comments address these fundamental issues and provide recommendations from corporate practice.

4.2.2 Content and organisational structure of the ICS for sustainability reporting

4.2.2.1 Separate or integrated ICS

When developing or expanding the ICS, it is useful to consider the process-related design. As controls are generally identified and set up in a process-oriented manner, the differentiated consideration of centralised and decentralised processes in particular offers an advantage with regard to an aspect for prioritisation in the implementation or expansion of the ICS for the sustainability report (see section 4.3). A similar approach has proven successful in the design of the ICS in Finance Departments: where there are also clearly defined processes that are used to set up dedicated controls.

In terms of content, the ICS for sustainability reporting can be set up as an independent system or integrated into the existing ICS, which then needs to be supplemented with data points for sustainability reporting. In many companies, certain quantitative data points, such

as the total volume of waste in tonnes, are already collected and reported separately. Other ESG data points, such as EU taxonomy data, can be found in the same systems that are used for financial reporting. It must be examined whether the existing ICS can be used and, if appropriate, further formalised or whether separate reporting is necessary due to operating sites that do not yet collect the key figures or due to inconsistent upstream systems in which data is collected. Consideration should be given to whether the integration of new data points into the financial reporting system is preferable due to the increasing connectivity of financial and ESG reporting.

In view of the quantity of data points to be collected and the large number of different stakeholders that have to provide them, it is advisable to initially access existing systems, to include marginal areas through estimates if necessary and to expand the ICS in a multi-year, risk orientated process. Unless a separate system is set up, it is recommended that the subsets of the ICS included be kept small. A standardised ICS or systems limited to a few parts of the ICS also have the advantage of greater clarity and thus clearer accountability.

4.2.2.2 Organisational integration & reporting structures

The content of the ICS for sustainability reporting is ultimately also reflected in the implementation of responsibilities and organisational structure within the company. If existing systems and processes of the financial ICS are used, it is only logical that an associated ICS for sustainability reporting should be organisationally anchored in the financial ICS and thus also in the Finance Department under the responsibility of the CFO.

The organisational integration into the financial or centralised ICS has fundamental advantages. The different divisions that provide the ESG information for reporting have little or no experience or expertise with the requirements that external reporting entails (completeness, consistency, etc.) and the processes required to enable auditability. The finance function, however, has many years of experience and the necessary processes and tools for establishing effective controls. It is therefore a suitable business partner for issues with ICS requirements. By contrast, the very different process maturity, a lower level of digitalisation and automation in ESG reporting can lead to challenges and require a change of perspective in order to define a realistic automation path.

Considering the connectivity between financial and ESG data from a reporting and management perspective, the decision to implement the ICS for sustainability reporting organisationally in the financial ICS area makes it easier to integrate both control systems into a holistic ICS in the medium term. This should also be the objective, as separating the two systems would complicate the consolidation of financial and sustainability reporting.

The question of organisational responsibility for sustainability reporting and the increasing tendency to locate this in the finance organisation is already reflected in corporate practice. For example, a survey conducted by the DRSC in 2023 revealed that in around half of the DAX 40 companies, project responsibility for ESRS implementation lies with the Chief Financial Officer (CFO) or the finance function within the company. The Chief Executive Officer (CEO)

was mentioned as the second most common responsible party.[22] The implementation in the finance function suggests that the organisational responsibility for ESG reporting and the ICS for sustainability reporting will ultimately lie with the CFO. This trend is already emerging among the participating companies.

4.2.3 Components of an internal control system

The scope of the ICS to be implemented or expanded depends on the number and complexity of the data points to be collected. EFRAG defines "data point" as qualitative information (*narrative*), semi-qualitative (*semi-narrative*) and quantitative information. Explanations and descriptions of facts in the narratives are based, for example, on documents relating to introduced or planned measures. The evidence to verify this information is usually based on this documentation, while further "evidence" is expressed in the quantitative information. In the case of semi-narratives that are pillared by poorly defined quantitative disclosures, it should be checked whether data collection is required. Quantitative information must be collected and aggregated across the group, which will require a formalised ICS for efficient identification and verification.

Analogous to the financial ICS, the *objectives* of an ICS for sustainability reporting are derived from the regulatory requirements and, where applicable, other requirements defined by the company management. In the ESG context, the scope of the requirements to be considered is primarily determined by the results of the materiality assessment, from which the topics and data points subject to reporting for the respective company are derived. It is necessary for these datapoints to define how the ICS ensures the complete, accurate and timely provision of this information.

On the way to a fully comprehensive, effective ICS for sustainability reporting, it may be useful to first prioritise the implementation of some central core elements that already make a significant contribution to improving data reliability and quality due to the low level of maturity. The order of the elements of an ICS listed below can be seen as such a prioritisation proposal. However, it should not be forgotten that an ICS should only be considered effective if all the elements listed below are established in the company and were suitable in all material aspects during the audited period to achieve the ICS objectives for the preparation of the sustainability report with reasonable assurance and were effective during the audited period. The latter must also be the objective regarding the prospective audit required with reasonable assurance (see also section 4.4).

22 Source: https://www.drsc.de/en/news/drsc-veroeffentlicht-ergebnisse-seiner-kurzumfrage-zur-esrs-implementierung-in-den-dax-40-unternehmen/

Core elements:

- *Risk assessment process:* Serves to identify the inherent and residual risks of the various sustainability information to be reported and thus their potential impact on CSRD/ESRS-compliant reporting. This step is essential for an ICS and it is advisable to start with it if an ICS has to be established from scratch. This way, particularly risky areas can be identified and resources (which may be limited) can be focussed on these areas.
- *Control activities:* They serve to counter the identified risks and must therefore be individually tailored to the results of the risk assessment. A control can be understood as an "action" to identify, prevent or mitigate errors or irregularities within a process. Depending on the process and data point, various controls can be used. Controls should be clearly defined and documented, including the person responsible.

The following **subordinate elements** also complement an ICS:

- *Control environment*: Describes the framework within which an ICS is introduced and applied. It includes aspects, such as the anchoring of essential values in the corporate culture, the code of conduct, the provision of relevant resources, the transparent allocation of roles and responsibilities, and the involvement of the Audit Committee.
- *Information and communication system:* Ensures that information and data are shared with relevant internal and external stakeholders in a complete, accurate, timely and systematic manner. The development of strategic, formal and, if possible, automated processes for sustainability reporting requires upskilling efforts, especially for those employees without explicit prior experience with internal controls, given the high number of stakeholders involved in many different functions.
- *Monitoring and improvement process:* Serves to assess whether the ICS is both appropriate and effective and comprises process-independent monitoring measures. This is an ongoing activity to ensure that the ICS can respond appropriately to changes – such as newly identified material and therefore issues to be disclosed. Specifically, this can include the following measures, for example: proactive cooperation with the Internal Audit Department with regard to the ICS report, analysing identified deficiencies and their causes, defining rules on how to deal with findings and additional audit activities by the Audit Committee. In order to ensure the effectiveness of the audit of the ICS, monitoring should be set up independently and separately from the actual execution of the ICS in organisational terms.

4.2.4 Criteria for prioritising ESG information

Due to company-specific factors of influence, the process for selecting and prioritising ESG information must be determined depending on the materiality assessment. In addition to statutory reporting obligations, there are other factors that may influence the selection of indicators. The implementation recommendations listed should therefore be viewed as a general categorisation that requires business specific adaptation. In the following, recommendations for the selection of relevant ESG KPIs are analysed. This is followed by a description of how an ICS for the ESG KPIs identified above and the underlying processes can be implemented for sustainability reporting. Implementation recommendations for possible prioritisation approaches are explained.

Selection of relevant ESG KPIs and information

It is generally advisable to select ESG KPIs and information based on three core factors:

1. *Materiality of the ESG factors,* i.e. focus on the key figures of the ESG topics that are reported as a result of the materiality assessment according to CSRD and that are being audited.[23]
2. *Most relevant/relevant ESG indicators (and information)*, which for example
   - are anchored in the remuneration of the Executive Board,
   - are disclosed in audited reports, such as the sustainability report,
   - have steering character for business activities and strategic sustainability goals,
   - have material risks associated with the KPI/information,
   - are published in other, unaudited parts of the report.
3. *Quantifiability of ESG information,* i.e. primarily quantitative data points to ensure and verify consistent data quality when collecting possibly very relevant qualitative ESG information.

Prioritisation within the ICS for sustainability reporting in the implementation phase

With increased complexity in the implementation of identified ESG KPIs, prioritisation within the ICS for sustainability reporting provides strategic decision-making support. A higher level of complexity can result, for example, from the scope of implementation (new development of the ICS for sustainability reporting versus expansion of the existing financial ICS), defined reporting requirements and the company structure. In practice, the following design factors provide guidance for effective prioritisation within the ICS for sustainability reporting, although they must be individually tailored to the circumstances of the respective company:

1. Prioritisation from a steering perspective ESRS or stakeholder perspective:
   - Relevance for corporate management

23 Please find further information in Chapter 1 "Double materiality".

- Internal reporting requirements including remuneration components
- Publicity of the reporting (internal or external)
- Planned year of implementation

2. Prioritisation from an ICS perspective:
    - Lower complexity of the KPIs, including a lower number of responsibilities involved
    - High data availability, implemented reporting mechanisms including maturity level of underlying processes and existing controls
    - Individual risk assessment of the company, the scope of consolidation and the operational control level
    - Findings from previous internal and external audits

In addition, the implementation as a first step can focus on centralised parts of the processes. More decentralised parts, which require more effort during implementation, could be developed in the first phase using a few examples in order to make the system visible. Completion can happen over time (see also section 4.3).

In addition to company-specific reporting obligations, a derivation of the ICS-relevant processes is necessary after selecting the modified or new ESG KPIs. It should be emphasised that synergy effects can also be created between controls of higher and lower prioritised KPIs. This is particularly the case when controls cover processes that are based on several KPIs. Depending on the maturity level of an already implemented ICS for sustainability reporting, it is possible to build on existing, controlled processes. In particular, the initial consideration of existing centralised versus decentralised processes provides supportive guidance.

4.3 Consideration of centralised and decentralised processes/controls

While centralised processes are controlled by a single or a few central units within the company, decentralised processes are characterised by (local) control across various units or locations within the company.

In order to optimise the design of the underlying processes and associated controls, it is advisable to classify the KPIs identified and prioritised above into decentralised or centralised process control. Different approaches, which are described below, can be derived from this.

The characterisation of centralised or decentralised processes and corresponding controls is initially highly dependent on the ESG KPI to be disclosed. For example, processes for consolidation and reporting are typically located centrally, but the collection of locally dependent information such as occupational accidents across all production sites is generally assigned to decentralised processes. Qualitative KPIs also represent a further level of

complexity in the design of procedural controls compared to quantitative KPIs due to their more difficult measurability or control. They are therefore often centrally managed and controlled.

The identification of necessary controls and their implementation should follow a control specific approach. In practice, it is advisable to consider

- existing requirements for KPI reporting from legislation or relevant stakeholders. In addition to other economic factors, this increases the relevance of control for the overall process.
- The underlying complexity of data collection and consolidation in the affected company divisions as well as options for plausibility checks of information by centralised or decentralised knowledge holders.

In principle, centralised processes and controls enable uniform and consistent reporting as well as centralised management and monitoring of ESG-relevant topics. This contributes to an increase in quality, validity and consistency of disclosed information. However, depending on the respective key figure, it is also conceivable or even necessary to monitor decentralised processes through an ICS for sustainability reporting. The management of decentralised processes is very complex, particularly due to the diversity in terms of process design and IT system landscape; as a result, they are also subject to higher expenses for the design and monitoring of the ICS for sustainability reporting.

Taking into account the aspects described above, an appropriate prioritisation should therefore be made when setting up and progressively professionalising the ICS related to ESG information. As a recommendation for the implementation process, for example, central processes can be prioritised first to achieve quick successes before implementing the ICS for sustainability reporting for decentralised processes with greater complexity. In any case, the necessary performance of a final internal review and approval of the sustainability reporting is recommended as a central control measure.

4.4 Internal monitoring as a basis for external auditing

In accordance with recommendation A.5 of the German Corporate Governance Code (GCGC) 2022, the Executive Board should comment on the appropriateness and effectiveness of the holistic RMS and ICS in the management report, thereby targeting financial and sustainability aspects in the same way. According to the Rationale of the Government Commission on the German Corporate Governance Code on recommendation A.5 of the GCGC 2022, an appropriate and effective internal control system [...] includes internal monitoring by the Executive Board. This monitoring creates the prerequisite for being able to issue a statement in accordance with recommendation A.5. Monitoring the internal control system [...] is one of the core tasks of Internal Audit.

In accordance with Section 171 (1) AktG, the Supervisory Board itself must review the sustainability reporting contained in the management report with the same intensity as it has previously reviewed the financial reporting. For the audit of the financial reporting, the Supervisory Board can rely on the statutory audit of the financial statements, which is carried out with reasonable assurance. For the audit of sustainability reporting, the Supervisory Board can generally only rely on an external audit with limited assurance. The Supervisory Board will have to weigh up how it can close this audit gap through its own audit procedures and whether it requires the company to focus more strongly on an appropriate and effective internal control system, which is a key influencing factor regarding data quality and the completeness and accuracy of sustainability reporting.

In addition to internal requirements, external requirements are also increasingly playing a role in the setup of ICS monitoring. Measured against the assurance level that will soon be required or internally targeted, the monitoring activities must be aligned along the lines of defence.

The decisive factor here is the assessment of the coverage of procedural risks, which can be assessed at an operational level, for example through self-assessments. In addition, global risk assessments (e.g. by the central ICS function) can be used to identify further material risks for the company and their adequate mitigation. Both perspectives also form an important basis for organising and mandating overarching governance functions that can perform the corresponding control, monitoring and reporting duties. Internal audit can perform an independent validation of the risk assessment, and the measures derived from it, monitor the targeted implementation of controls and incorporate the entire ICS annual cycle into the audit activities.

To summarize, the respective measures must be determined individually for each company by internal lines of defence and their assessment from an external perspective. This can be based on existing structures and the requirements of the management and supervisory bodies.

The degree of appropriateness and the extent of effectiveness of the internal control system for CSRD/ESRS sustainability reporting form an important basis for the planning and performance of the external audit of sustainability reporting, in particular for the assessment of error risk and the type and scope of the audit procedures to be performed. An appropriate and effective ICS enables the external auditor to adjust and, if necessary, limit or focus the audit procedures depending on the desired audit assurance level.

The starting point for a limited assurance engagement on sustainability reporting is to gain an understanding of the disclosures and the underlying business processes and to identify, on a risk-oriented basis, those disclosures that are likely to contain material misstatements. Subsequently, audit procedures should be focused on these disclosures and, if the ICS is lacking or is deemed ineffective, may lead to additional, more extensive case-by-case audit procedures that place a corresponding burden on resources at company level in the ongoing audit process. In case of limited assurance audits, however, the level of assurance is far lower than in the case of reasonable assurance audits, as the audit procedures are essentially based

on inquiries and analytical audit procedures and audits of any internal controls – as a key driver of data quality – are largely omitted.

The external assurance engagement on the sustainability reporting with reasonable assurance covers the processes and control systems relevant to sustainability reporting and examines the adequacy (design & implementation) and, where appropriate, the operating effectiveness of relevant internal controls, but does not aim to provide an independent opinion on the adequacy and effectiveness of internal controls over sustainability reporting.

The following table compares the audit procedures relating to the ICS – including the ICS relating to sustainability information – at the respective audit level:

	Testing with limited security	Testing with reasonable assurance
	Understand	**Understand & evaluate**
Control environment	✓	✓
Information system	✓	✓
Risk assessment process of the company	Only the results	✓
Control activities	Possibly	✓
The company's process for monitoring the ICS	✓	✓

The IDW has developed a Praxishinweis 4/2023 "Ausgestaltung und Prüfung des internen Kontrollsystems zur Aufstellung eines Nachhaltigkeitsberichts unter Beachtung des IDW PS982" to support companies in complying with the requirements for an effective internal control system and to provide auditors with guidelines for a standardised approach to audit this control system.

4.5 Recommendations based on business practice

In principle, the report published by COSO on an effective internal control system for sustainability reporting offers comprehensive explanations. The top 10 takeaways on effective ICS in sustainability reporting on page 105 of the report are a useful initial guide. As a supplement and partial confirmation of the COSO findings, this section summarises the most relevant recommendations from corporate practice based on experience.

A top-down process is seen as advantageous for the efficient implementation of the ICS for sustainability reporting. It is generally advisable to involve experts from existing ICSs and to enlist them as sparring partners to understand the approaches of existing ICSs – their design

principles – and to enable efficient implementation, considering previous experiences and lessons learnt.

Based on a sound understanding of the design principles, the transferability to the ICS for sustainability reporting can be examined to utilise proven approaches, tools used, experience already gained and learning effects and, if applicable, references to existing parts. Depending on the findings, the participating companies often favoured a separate structure (for the time being) for the ICS for sustainability reporting.

The ESG KPIs and information should be clustered according to relevance, whereby quantitative data points are considered first and then, if necessary, highly relevant selected qualitative data points (see section 0). A grouping and corresponding prioritisation into data points relevant for Management Board remuneration, audit and steering is highly recommended to determine the scope of the ICS and the order of implementation.

The application of the design principles and knowledge gained from existing ICS is crucial. For most of the participating companies, this includes a process orientated approach that provides for the clustering of ESG KPIs and information according to key functions and processes. The development of a "toolbox" with processes on the one hand and standardised controls on the other hand is key for an efficient ICS structure.

The determination of the necessary documentation of processes and controls should ideally be piloted and optimised by means of a proof of concept using a simple example, ideally with illustration in the potentially used IT system. This serves as a basis for all further processes and indicators and has a significant impact on the subsequent ICS management for sustainability reporting.

The planning and prioritisation of the clustered functions and processes is necessary to develop the necessary process description, identify the process risks and assign the controls. As a next step, the controls must be assigned to specific roles that assume the function of the respective "control owner". As mentioned in the previous sections, it is recommended to focus on centralised process parts in the initial implementation phase. Completion of the decentralised process components and assignment of the controls to the specific role owners in the usually numerous operational units can only be developed using examples and can only be fully implemented in a second step.

List of abbreviations

AktG	Aktiengesetz (German Stock Corporation Act)
AR	Application Requirement
ASCG	Accounting Standards Committee of Germany (DRSC)
CapEx	Capital Expenditures
CDP	Carbon Disclosure Project
COSO	Committee of Sponsoring Organisations
CSRD	Corporate Sustainability Reporting Directive
DCGK	Deutscher Corporate Governance Kodex (German Corporate Governance Code)
DNSH	Do no significant harm
EFRAG	European Financial Reporting Advisory Group
ESG	Environmental, Social and Governance
ESRS	European Sustainability Reporting Standards
FISG	Gesetz zur Stärkung der Finanzmarktintegrität (Financial Market Integrity Strengthening Act)
GHG	Greenhouse Gas Protocol
GRI	Global Reporting Initiative
HGB	Handelsgesetzbuch (German Commercial Code)
ICSR	Internal Control over Sustainability Reporting
IDW	Institut der Wirtschaftsprüfer in Deutschland e.V. (Institute of Public Auditors in Germany)
IFRS	International Financial Reporting Standards
IKS	Internes Kontrollsystem (internal control system)
IPCC	Intergovernmental Panel on Climate Change
IRO	Impacts, Risks and Opportunities
ISSB	International Sustainability Standards Board
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (German Act on Control and Transparency in the Corporate Sector)
KPI	Key Performance Indicator
LkSG	Lieferkettensorgfaltspflichtengesetz (German Supply Chain Due Diligence Act)
NGO	Non-Governmental Organisation
OpEx	Operating/Operational Expenditures
PAI	Principal Adverse Impact
RFP	Request for Proposal
RMS	Risikomanagementsystem (risk management system)
SBM	Strategy Business Model
SBTi	Science Based Targets initiative
SFDR	Sustainable Finance Disclosure Regulation
SWOT	Strengths, Weaknesses, Opportunities, Threats
VC	Value Chain

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The considerations presented in the discussion paper reflect the views held by the majority of the project group.

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