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LSME ESRS: SR TEG

Discussion paper

Background

- 1 EFRAG work on SMEs comprises of a mandate for technical advice for simplified listed SMEs ESRS (art 29c CSRD) ('LSME ESRS'), which will be legally binding (delegated acts) for small and medium enterprises whose securities are admitted to trading on a regulated market in the Union.
- 2 In addition, EFRAG received a recommendation to develop a Voluntary Sustainability Reporting Standard for non-listed SMEs ('VSME standard'), that the European Commission (EC) would adopt/endorse (as «recommendation» of the EC, not a delegated act, not binding). In particular, the EC's impact analysis accompanying the CSRD stated that *simplified reporting standards will be developed for SMEs to use on a voluntary basis. These should enable SMEs to meet information demands from large company clients and banks, and will facilitate their contribution to and participation in the transition to a sustainable economy.*
- 3 The text of the CSRD specifies:
 - (a) the expected content of the LSME ESRS; and
 - (b) that the content of the main ESRS (i.e. the draft ESRS delivered by EFRAG in Set 1 in November 2022 to the EC) cannot result in the large companies (in scope of Set 1) having to request that SMEs in their their value chain deliver information that exceeds what is required in LSME ESRS (we refer to this feature as LSME setting a 'cap' for the content of Set 1). As a result, in developing LSME ESRS EFRAG will have to counterbalance the need for proportionality with the need to still preserve the feasibility for large companies to provide a relevant information when reporting on their value chain.
- 4 As the two documents (LSME ESRS and VSME standard) have a different legal status, they serve different purposes and they are addressed to different groups of entities, the EFRAG Secretariat consider it necessary to issue them as two separate documents.

Purpose of LSME ESRS and minimum required content

- 5 Listed SMEs may adopt the main standards, but are also granted by the CSRD the possibility of reporting in accordance with standards that are proportionate to their capacities and resources, and relevant to the scale and complexity of their activities.

- 6 The purpose of LSME ESRS is:
- (a) to ensure that the investors that buy their listed securities receive information on sustainability matters and in this way avoid discrimination against small and medium-sized undertakings due to a different level of sustainability information produced; and
 - (b) to ensure that financial market participants have the information they need from investee undertakings to be able to comply with SFDR requirements. their own sustainability disclosure requirements laid down in Regulation (EU) 2019/2088 (SFDR regulation).
- 7 The CSRD text explains that *in order to ensure investor protection, it is appropriate to require that also small and medium-sized undertakings, except micro undertakings, whose securities are admitted to trading on a regulated market in the Union disclose information on sustainability matters. The introduction of such a requirement will help to ensure that financial market participants can include smaller undertakings whose securities are admitted to trading on a regulated market in the Union in investment portfolios on the basis that they report the sustainability information that financial market participants need. It will therefore help to protect and enhance the access of smaller undertakings whose securities are admitted to trading on a regulated market in the Union to financial capital, and avoid discrimination against such undertakings on the part of financial market participants. The introduction of the requirement for small and medium-sized undertakings, except micro undertakings, whose securities are admitted to trading on a regulated market in the Union to disclose information on sustainability matters is also necessary to ensure that financial market participants have the information they need from investee undertakings to be able to comply with their own sustainability disclosure requirements laid down in Regulation (EU) 2019/2088.*
- 8 The standard will be applied by approx. 1.1 thousand companies listed in the EU and by about 2.3 thousand small and non-complex financial institutions. The number of captive insurance and reinsurances under scope is not yet available.
- 9 Art 19a (6) of the Accounting Directive as modified by the CSRD specifies the content of simplified sustainability reporting for listed SMEs. This is a list broadly aligned with the reporting areas for the main standards in the CSRD. However
- (a) many of the detailed reporting contents applicable to the large undertakings within those reporting areas are not explicitly required for listed SMEs, i.e.
 - (i) resilience,
 - (ii) opportunities,
 - (iii) transition plans in line with Paris agreement, climate law and exposure to coal and mining,
 - (iv) how the business model and strategy take account of the interests of the undertaking's stakeholders,
 - (v) implementation of the strategy,
 - (vi) own operations and value chain, including its products and services, its business relationships and its supply chain in adverse impact,
 - (vii) dependencies.

- (b) the following identified reporting areas are not explicitly included in the list of reporting areas to be covered by listed SMEs:
 - (i) description of due diligence process
 - (ii) role of administrative, management and supervisory bodies in sustainability matters,
 - (iii) targets and progresses,
 - (iv) financial plans and resources.
- 10 ESRS LSME shall also consider article 29 b (par. 2 to 5), i.e. it should take into account the international initiatives and EU regulation listed in art 29b (5) like the ESRS for large undertakings. ESRS LSME shall include the information related to SFDR PAI and art 8 Taxonomy Regulation [Recital 17 and 21].

Previous SR TEG and SRB discussions on LSME ESRS

- 11 On 5 December and 12 December 2022, SR TEG members discussed the approach to the Development of ESRS for Listed SMEs (ESRS LSME). On 14 December 2022 the SRB was informed about the outcome of those discussions.
- 12 The two papers discussed at these meetings are available at the following links:

[Download \(efrag.org\)](https://www.efrag.org)

<https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FMeeting%20Documents%2F2212081403230833%2FAppendix%201-%20Issues%20Paper%2003-01-%20CSRD%20provisions%20listed%20SMEs%20TEG%2005122022%20Revised.pdf>

Proposal by the EFRAG Secretariat presented to SR TEG on 5 and 12 December 2022

- 13 The proposal of the EFRAG Secretariat foresees the following approach:
 - (a) With reference to targets and financial plans, the reporting would be limited to state whether the undertaking do has targets and plans and expand the content only when such targets/plans do exist;
 - (b) Role of the administrative, management and supervisory bodies: to completely exclude this point would limit the coverage of governance matters. The EFRAG Secretariat proposes to include a simplified version of GOV 1 in the standard for listed SMEs. This would also allow to cover the ratio male/female members in the board;
 - (c) Due diligence: as part of the required statement on policies, actions and targets (limited to matters that are assessed to be material – see paragraph on Architecture below), the undertaking would be required to disclose whether and to what extent it has implemented sustainability due diligence processes as defined in the relevant OECD, UNGP and ILO instruments (to be able to comply with the SFDR and Benchmark Regulation datapoints).
 - (d) With reference to the topical standards, the EFRAG Secretariat would propose the following: policies, targets and actions would be covered by a centralised disclosure covering material matters to the extent that the undertaking has implemented policies, targets and actions. This would allow to simplify the chapters dedicated to each topic and in particular, the only additional content required would be the datapoints in Appendix C ESRS 2 (mandatory for EU regulation).

14 The proposal of the EFRAG Secretariat foresees the following Architecture:

ESRS 1	<p>To incorporate by reference ESRS 1, while amending some of the principles in ESRS 1 to listed SMEs peculiarities (i.e. approach to due diligence, value chain, materiality and stakeholders interest).</p> <p>Characteristics of quality in ESRS 1 applicable.</p> <p>Entity-specific disclosure applicable.</p> <p>List of sustainability matters in ESRS 1 App. B applicable.</p>
ESRS 2	<p>This would imply rewrite of ESRS 2 with adaptation required by CSRD on listed SMEs. That would lead to the following potential table of content: BP1 General basis for preparation of the sustainability statements; BP2 Disclosures in relation to specific circumstances; D GOV1 The role of the administrative, management and supervisory bodies (inc. male female ratio, SFDR); SBM1: Market position, strategy, business model(s) and value chain (simplified and include the breakdown of revenue by sector); SBM 3 Material impacts, risks and opportunities and their interaction with strategy and business model(s); IRO1: simplified; IRO2: entire. DC-A, DC-P and DC-T , DC-M would not be included.</p> <p>Instead, the standard would require to report a statement on policies, targets and actions, limited to matters assessed as material, plus climate. The undertaking would comply with a statement that it has not adopted targets and may report a timeline for adoption, where appropriate.</p>
Environmental Disclosures	<p>Metrics only: SFDR PAIs, Taxonomy and Benchmark Regulation (plus EBA Pillar 3 ESG risk), always to be reported.</p> <p>The disclosure requirement would match the disclosure requirements and datapoints listed in Annex C of ESRS 2.</p>
Social Disclosures	<p>Metrics only: SFDR PAIs and Benchmark Regulations, always to be reported.</p>
Social Governance	<p>Metrics only: SFDR PAIs and Benchmark Regulations, always to be reported.</p>

Main messages from the SR TEG meeting 5 December 2022

- 15 Members expressed support with the structure of the proposal, but would need to see in detail the disclosures required from listed SMEs.
- 16 Members agreed that the metrics required in SFDR, Pillar 3 and benchmark will be mandatory, which is a good position to preserve the value chain cap.
- 17 Some members supported the idea that the list of sustainability matters for the listed SMEs should not be different from the list applicable to large undertakings and it would be a question of materiality.
- 18 Members considered that sector-specific requirements are needed also for listed SMEs. They agreed with the suggested approach to define first a sector-agnostic ESRS for listed SMEs, and to consider, in conjunction with the preparation of the sector-specific standards, the question to whether and which simplifications are needed for listed SMEs in each and every sector. Accordingly, specific questions would be included in the consultation of the

sector specific draft ESRS. In practical terms, this would mean that the listed SME standard issued as part of Set 2 would be sector-agnostic and, depending on the outcome of the consultation on each sector-standards, specific guidance could be considered (in subsequent sets and not already in Set 2) on how the content of the sector specific draft ESRS would be applied by listed SMEs. One EFRAG SR TEG member asked whether the list of listed SMEs could be analyzed to understand from which sectors the listed SMEs are mainly belonging too. EFRAG secretariat confirmed ongoing work on this.

- 19 One EFRAG SR TEG member challenged the proposal that in the social section of the standard for listed SMES « the number of DRs shall be limited to ...SFDR PAI indicators and Benchmark Regulation » and asked what is considered “disproportionate” in the mandatory social disclosure requirements for large undertakings that were not retained for listed SMEs. He suggested to add at least the GRI universal standard DRs (number of employees, non-employee workers, collective bargaining coverage). He added that, on the basis of the experience in Set 1, the decisions on which DR are to be included needs to be supported by a consistent methodology.
- 20 Some EFRAG SR TEG members underlined that the approach to proportionality may need further elaboration. The following was noted:
 - (a) Simplification is justified provided that the SMEs occupy a ‘simpler’ place in the value chain, i.e. proportionality should not override materiality.
 - (b) One EFRAG SR TEG member suggested that that proportionality is driven by materiality, i.e. SMEs should be allowed to apply a higher threshold of materiality (e.g. report only the most material impacts/risks/opportunities). Other SR TEG members/observers questioned this concept. One EFRAG SR TEG member wondered whether this approach is consistent with impact materiality, as significant impacts should be reported even in the case of SMEs (same approach for listed SMEs and large undertakings). One EFRAG SR TEG member said the approach to set a higher bar for materiality is conceptually appealing but in contradiction with the spirit of CSRD.
 - (c) One EFRAG SR TEG member considered that for the sake of proportionality, materiality assessment should not be required from listed SMEs (i.e. only mandatory DRs) as it is an overly sophisticated process.
- 21 One EFRAG SR TEG member said that one important issue will be to ensure the consistency of sectorial standards across the value chain. This is an additional argument to have more consistency in the sectorial standards between SMEs and large undertakings, than in the agnostic standards.
- 22 One EFRAG SR TEG member raised a concern related to the proposal on policies and action plans. Considering the interaction between the listed SME standard and the main standards due to the cap, for large companies, getting quantitative data from listed SMEs will be more useful than getting information on policies. The fact that the information required will be more qualitative than quantitative is a challenge. This member suggested to require to listed SMEs to disclose a map of the business partners of the listed SMEs (amount spent, geography and sector). This approach however was questioned by other members, as this would result in requiring to listed SMEs a disclosure that is currently not required in the main standards.

Main messages from the SR TEG meeting 12 December 2022

- 23 An overview of listed SMEs with distribution by economic sector of activity was presented: the overview shows that the sectors that are most representative

for listed SMEs are: Information technology (20,4%), Industrials (15,2%), Healthcare (13,1%) and Consumer Luxury (11,9%).

- 24 The members agreed in principle with the proposed approach and decision tree. They also agreed not to include a definition of 'proportionality'. The implementation of proportionality would be documented by the decision tree.
- 25 Noting that the list of proposed DR didn't include S1/S9, some members considered that in the decision tree it would be appropriate to ask a final question on whether the outcome of the analysis was striking the right overall balance between costs and benefits. Following this approach, S1/S9 could be included and subject to materiality assessment. In addition, a simplification in terms of granularity could be proposed to these DR and the number of employees should be always mandatory. It was noted that making S1/S9 mandatory would contradict the content of ESRS 1 where these DR are mandatory only for undertakings with 250+ employees.
- 26 The following main observations were made by individual members:
 - (a) Use of a higher threshold of materiality for LSME versus main standards: the idea of using a higher threshold (e.g. most material IRO instead of material) was reiterated by the member that proposed it on the 5 December, but it didn't find support in other members.
 - (b) SFDR/Benchmark Regulation/Pillar 3 requirements should be subject to materiality assessment: undertakings applying LSME should be able to declare that a given datapoint is omitted as it corresponds to a less than significant amount. Alternatively (or in addition), mandatory DRs for listed SMEs could be limited to the mandatory SFDR PAIs (Table 1), while the optional SFDR PAIs could be subject to materiality assessment. It was noted that it is essential to confirm that, if the SFDR/Benchmark Regulation/Pillar 3 requirements are not mandatory but subject to materiality, they are still maintained as valid request in the context of the 'cap for value chain' (i.e. large undertakings would be allowed to ask the relevant data to their value chain counterparties as these indicators are included in the LSME standard, albeit not mandatory).
 - (c) GOV 4 should be maintained as there is an explicit reference in the CSRD for LSME to the steps of due diligence.
 - (d) Interaction between sector standards and LSME: in the consultation on sectors, a specific question could be asked to collect views on the approach to be taken for LSME (e.g. do we need a tailored LSME annex per each sector? Should the sector ESRS be entirely applicable also to LSMEs? Should it be mandatory?). The questions could also be included horizontally, i.e. raised in the context of the LSME consultation instead of in each and every sector.

Main messages from the SRB meeting 14 December 2022

- 27 General support was expressed by EFRAG SRB members on the overall approach, although some SRB Members highlighted that more details would be needed for a complete assessment.
- 28 Some EFRAG SRB members questioned the need of two separate standards. EFRAG SRB Chair explained that the SME community has requested to have a separate tailor-made VSME standard beside the LSME standard mandated by the CSRD. In addition, the two standards will have a different legal status (LSME issued as delegated act, VSME as recommendation).
- 29 Some EFRAG SRB members reminded the importance of the VSME standard to allow for simplified reporting. This is an important tool for banks to gather

data from SMEs clients. Some members reminded that the main reason to have a LSME standard is the legal requirement in CSRD, judging that the business case would be stronger for VSME standard.

- 30 Discussions focused on whether, when assessing the approach and methodology for the LSME standard, EFRAG SRB should look more at the listed aspect or at the SMEs aspect. Different views emerged though it was highlighted that listed SMEs would always have the option to apply the ESRS for large undertakings. Some EFRAG SRB members emphasized the SME aspect, hence avoid overburdening small companies, while capturing key sustainability indicators and risks. Other EFRAG SRB members emphasized the listed aspect indicating that if small companies issue listed securities in regulated market, the public accountability element shall prevail, in same way as for large listed companies. It has to be noted however that the content of the LSME standard is already identified in the CSRD. In addition, it was emphasised that the content of the listed SME sets the limit of the information that ESRS main standards (Set 1) can require. In particular, ESRS cannot require disclosures that would mean getting value chain information that exceeds the disclosures set in the standard for LSMEs.
- 31 EFRAG SRB members generally (but not all of them) supported the two LSME and VSME standards due to legal provisions and different aims. They agreed that the two shall be aligned as much as possible to fit in the logic of a modular approach of building blocks. Although VSME could be much simpler in style and, to a certain extent, in language. An important element for both standards would be guidance and less level of granularity. One proposal was to have a very narrow framework for VSME with basic reporting and once topics are triggered in the materiality assessment, the undertaking would refer to the higher building blocks framework.

Update on SMEs Communities

- 32 To accompany the process of developing the LSME ESRS and VSME ESRS (voluntary standard for non-listed SMEs), beside the existing Expert Working Group, the EFRAG secretariat has set-up two new communities of stakeholders that have a direct experience in relation to SMEs and that have an interest to participate in the development of the draft standards.

Timeline for the draft ESRS

- 33 ESRS LSME has to be included in Set 2 (consultation in 1H23, issuance in November 2023). ESRS VSME on the contrary will not be issued as a Delegated Act, but as a separate document and, as such, could be put in consultation later than Set 2, allowing to discuss and approve the ED at SR TEG and SRB during the consultation of Set 2. As the period needed by the EC to finalize this document is in principle shorter than the issuance of a Delegated Act, ESRS VSME could be issued as final at the same time or few months later than ESRS LSME.
- 34 The amendment to Set 1 in order to implement the 'cap' would take place as part of Set 3 (consultation in 1H24, issuance in November 2024). It cannot be initiated before the finalization (after the consultation) of ESRS LSME.

Objective of LSMEs session (17 January 2023)

- 35 **The purpose of this session is to collect input from SR TEG members and observers on a number of methodological questions that will inform the drafting process for LSME ESRS.**

Drafting question:**Incorporation by reference to other Set 1 standards**

- 36 When discussing the approach to drafting the General Requirements in LSME ESRS, EFRAG SR TEG supported the direction of incorporating by reference contents of ESRS 1, while amending some of the principles in ESRS 1 to listed SMEs peculiarities. Under this approach, the text of the LSME ESRS would not be accessible without consulting also the text of ESRS 1. ESRS 1 would be applicable with a number of simplifications and adaptations. The LSME ESRS would detail such simplifications, while making reference to the text of ESRS 1 as a basis.
- 37 The alternative to the incorporation by reference, is the re-drafting of the standard (which would result in a very long standard as in the same document we have to incorporate the provisions of all the 12 standards). Below it is reported an example of adaptation to the LSME peculiarities of the Objective of the Standard:

ESRS 1	PROPOSED LSME
<p>Objective</p> <p>1. The objective of this [draft] Standard is to set out the general requirements that undertakings shall comply with when preparing and presenting sustainability-related information under the Accounting Directive as amended by the Corporate Sustainability Reporting Directive (CSRD).</p>	<p>Objective</p> <p>1. The objective of this [draft] Standard is to set out the general requirements (Section 1), General disclosures (Section 2) and Topical Disclosure requirements (Sections 3, 4 and 5) that shall be applied when preparing and presenting sustainability-related information under the Accounting Directive as amended by the Corporate Sustainability Reporting Directive (CSRD), by the following undertakings, together and hereafter the "LSME" or "undertaking":</p> <ul style="list-style-type: none"> a) small and medium-sized undertakings, which are public-interest entities according to point (a) of point (1) of article 2 of Directive 2013/34/EU - referred to in Art. 19 a (1) and (6) of the Corporate Sustainability Reporting Directive (CSRD) ; b) small non -complex financial institutions defined in point (145) of Article 4(1) of Regulation (EU) No 575/2013; c) captive insurance undertakings defined in point (2) of Article 13 of Directive 2009/138/EC of the European Parliament and of the Council ; and d) captive reinsurance undertakings defined in point (5) of Article 13 of that same Directive.

- 38 Before confirming the feasibility of the incorporation by reference as a general drafting principle, an element to consider is the complication and legal uncertainty originated from the fact that to apply the provisions in the standard, an undertaking has to refer to two different Legal Acts. In addition, the LSME ESRS ED would have to make reference to a delegated act that will only be finalised in June 2023 (so in principle subject to change).
- 39 In order to avoid this problem, an alternative would be to define a standalone document, adapting and simplifying the GRs of Set 1. This may also be appropriate from a user-friendliness simplification perspective.

Undue cost

- 40 When discussing the approach to drafting Set 1, EFRAG SR TEG and Board considered and decided not to apply the concept of undue cost as one of the qualitative characteristics of the information, considering it not compatible with the purpose of the standard setting to enhance the quality of the reported information for large undertakings.

- 41 Given the specificities of SMEs and in particular the need to develop requirements that are proportionate (according to CSRD) to their organisation and resources, consideration could be given on whether to introduce the undue cost principle in the draft LSME Standard. In particular, the CSRD speaks about standards that are proportionate to the capacities and resources of the SME, and relevant to the scale and complexity of its activities. The EFRAG Secretariat notes that the concept of proportionality is accompanied by a consideration for the complexity of its activities, so that proportionality doesn't overrides complexity.
- 42 For example, IFRS for SMEs includes the undue cost as one of the qualitative characteristics of information. "Applying a requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information".

Content question:

Opportunities and Targets

- 43 With regards to opportunities and targets, art 19a6 CSRD does not cover them explicitly as reporting requirement.
- 44 The EFRAG Secretariat proposes that LSME ESRS excludes opportunities from the required reporting areas and foresees to include them as voluntary content, for proportionality consideration. This would have limited adverse impacts on the implementation of the 'cap' as the cap relates primarily to impacts and risks.
- 45 DRs and ARs related to opportunities would be included as "may disclose" in the topical section.
- 46 Moreover the list of reporting areas shall be adapted from IRO (impacts, risks and opportunities) to IR (impacts and risk) with no explicit content for opportunities. This would imply also a specification that the disclosure on opportunities may be performed on a voluntary basis in General Principles. Hence the definition of the concept of opportunities shall be defined in draft LSME .
- 47 For targets, the proposal is to require to include them only to the extent that the undertaking has established targets.

Definition of impacts

- 48 CSRD in art. art 19a (6) letter c refers to "principal actual or potential adverse impacts of the undertaking on sustainability matters" that is a central concept compared to the voluntary approach proposed for opportunities (not explicit content in art 19a (6)).
- 49 For proportionality consideration, a deviation compared to main ESRS could be exclusion of "positive impacts" from the draft LSME ESRS.

Qualitative characteristics of information

- 50 In relation to the paragraph "Qualitative characteristics of information", the text of Appendix C has been summarised and only the first 2 paragraphs per each quality characteristics have been retained, to simplify it.
- 51 See proposal below:

ESRS 1	PROPOSED LSME
<p>2. Qualitative characteristics of information</p> <p>23. When preparing its sustainability statements, the undertaking shall apply:</p>	<p>2. Qualitative characteristics of information</p> <p>8. When preparing its sustainability statements, the undertaking shall apply the fundamental qualitative characteristics of information, i.e., relevance and faithful representation; and the enhancing qualitative</p>

ESRS 1	PROPOSED LSME
<p>(a) the fundamental qualitative characteristics of information, i.e., relevance and faithful representation; and</p> <p>(b) the enhancing qualitative characteristics of information, i.e., comparability, verifiability and understandability.</p> <p>24. These qualitative characteristics of information are defined and described in Appendix C of this [draft] Standard.</p>	<p>characteristics of information, i.e., comparability, verifiability and understandability. These qualitative characteristics of information are defined below.</p> <p>Relevance</p> <p>9. Sustainability information is relevant when it may make a difference in the decisions of users under a double materiality approach. Sustainability information may impact decisions of users if it has predictive value, confirmatory value or both. Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates, as assessed in the context of the undertaking's sustainability reporting.</p> <p>Faithful representation</p> <p>10. To be useful, the information must not only represent relevant phenomena, it must also faithfully represent the substance of the phenomena that it purports to represent. Faithful representation requires information to be (i) complete, (ii) neutral and (iii) free from error. A complete depiction of an impact or a risk includes all material information necessary for the users to understand that impact or risk. This includes how the undertaking has adapted its strategy, risk management and governance in response to that impact or risk, as well as the metrics identified to set targets and measure performance. A neutral depiction is without bias in its selection or disclosure of information. It shall be balanced, so as to cover favourable/positive and unfavourable/negative aspects. Information can be accurate without being perfectly precise in all respects. Accurate information implies that the undertaking has implemented adequate processes and internal controls to avoid material errors or material misstatements. As such, estimates shall be presented with a clear emphasis on their possible limitations and associated uncertainty.</p> <p>Comparability</p> <p>12. Sustainability information is comparable when it can be compared with information provided by the undertaking in previous periods and, can be compared with information provided by other undertakings, in particular those with similar activities or operating within the same industry. A point of reference for comparison can be a target, a baseline, an industry benchmark, comparable information from either other undertakings or from an internationally recognised organisation, etc.</p> <p>Verifiability</p> <p>13. Verifiability helps to give users confidence that information is complete, neutral and accurate. Sustainability information is verifiable if it is possible to corroborate either such information itself or the inputs used to derive it.</p> <p>Understandability</p> <p>14. Sustainability information is understandable when it is clear, and concise. Understandable information enables any reasonable knowledgeable user to readily comprehend the information being communicated.</p>

Approach to the value chain

52 At SR TEG 12 December the following principles-based approach was agreed:

- (a) The SFDR, Pillar 3 and Benchmark indicators would continue to be defined according to the applicable technical standards (no specifications needed in ESRS);
 - (b) Inclusion of value chain information for SBM 3 (identification of material impacts and risks), with the same approach as in ESRS 1;
 - (c) On policies, targets, action plans (and transition plans where applicable), the undertaking would be required to include value chain information to the extent that its policies, targets and action plans do consider/cover/involve entities in their value chain.
- 53 For the area of policies, targets and actions, which role would you consider the collection of information from SMEs in the value chain will have? The extent to which these items are to be covered in the sustainability statements of a large undertaking reflects the extent of the involvement with value chain counterparties in their current undertaking's business management practices (e.g. contractual agreements with the suppliers, codes of conduct signed by the suppliers, audit and surveys over suppliers, etc.). On this basis, to what extent would you consider that in order to be able to prepare its sustainability statements (limited to policies, actions and targets) an undertaking would in practice have to collect ad hoc information from the counterparties? Would you consider that the information available as part of the internal management reporting are sufficient in order to produce the necessary disclosure?
- 54 For the area of metrics, the EFRAG Secretariat considers that particular attention shall be given to the feasibility for the large undertakings to fulfil the mandatory disclosure of SFDR/Pillar 3 and Benchmark indicators (see section below).

Approach to materiality

a. Indicators stemming from EU regulation (incl. SFDR)

- 55 When looking at the possible simplifications to be introduced in the LSME standard, EFRAG has to consider the unintended consequences that the simplifications may have on the possibility of large undertakings to collect information that they need to meet the requirements in Set 1.
- 56 The CSRD mentions in the recitals the need to facilitate the implementation of SFDR by financial market participants in the objectives of LSME. As a consequence, EFRAG Secretariat considers that LSME should include the entire list of SFRD PAI as a requirement, in order to secure the possibility for large undertakings to collect the necessary data.
- 57 Nevertheless a specific discussion is needed on how to implement a proportionate approach to LSME, i.e. what type of simplifications can be envisaged compared to Set 1 for SFDR indicators. In this discussion attention should be paid to the possible interpretations of the value chain cap since the LSME ESRS will constitute a reference for large undertakings regarding the level of sustainability information that they could reasonably request from small and medium-sized undertakings in their supply chain.
- 58 On the assumption that including the full list of SFDR PAIs in the LSME ESRS as subject to materiality assessment would still guarantee that large undertakings could ask the corresponding sustainability information from their value chain SME counterparties, the EFRAG secretariat considers that this solution (SFDR PAI subject to materiality assessment) would constitute a viable simplification compared to set 1 ESRS.

- 59 The EFRAG Secretariat acknowledges that under such an approach, financial market participants with investments in LSME would have access to the SFDR PAI of their LSME investees only to the extent that the corresponding information is assessed to be material; this would impair their ability to aggregate data that are non-material when referred to an individual exposure but can become material when considered at a portfolio level. However, the EFRAG Secretariat considers that a cost-benefit perspective should be adopted. LSME ESRS will apply to approx. 1,000 undertakings, as opposed to 2 millions of non listed SMEs in Europe that also are in the portfolios of financial institutions. The EFRAG Secretariat considers that requiring to disclose mandatorily (outside the materiality assessment) all the SFDR indicators to all the SMEs (i.e. in the VSME ESRS) would be disproportionate. Consequently, the benefit of requiring that LSMEs report all the SFDR indicators mandatorily would not be justified by a cost-benefit perspective, considering the relative size of the market compared to the non listed SMEs.
- 60 The same assumptions could be made for the Disclosure Requirements and datapoints related to Benchmark Regulation and EBA Pillar 3 ESG risk.

b. Alignment with approach in Set 1

- 61 EFRAG Secretariat recommendation:
- (a) E1 and ESRS 2 (limited to disclosures listed in par. 14 above) to be always mandatory (outside materiality approach);
 - (b) Paragraphs 32/39 of ESRS 1 applicable with the following difference: the list of datapoints required by EU law would be subject to materiality instead of being mandatory.
 - (c) Future ESRS sector standards: to what extent make them applicable to listed SMES? What type of consultation questions could we ask to collect constituents views on this aspect? From a timeline perspective the LSME level would have to be considered after each ESRS sector standard.
 - (d) Do you think that in LSME there should be more space for materiality assessment (as this provides flexibility and so reduces the burden) or less space for materiality assessment (as the exercise of judgement result in the need to have more dedicated resources and more mature processes than the average situation in an SME)? How such additional or reduced space could be operationalised?

Table of content of LSME and DRs

- 62 Reference is made to the xls (decision tree) – See “Possible list of DRs in LSME with decision tree” in Annex. This Annex offers a preview of the list of DRs that will be included in the draft for SR TEG discussion. It reflects the outcome of the SR TEG discussions in December.

Questions to SR TEG members and observers

With reference to paragraphs under “Incorporation by reference to other Set 1 Standards”

Q1) Do you agree with the proposed text on objectives for LSME?

Q2) Do you agree with defining a standalone Standard without adopting the incorporation by reference approach?

With reference to paragraphs under “Undue cost”

Q3) Do you agree to introduce, as deviation from the main ESRS, the principle of “undue cost” in LSME Standard (for proportionality consideration)?

With reference to paragraphs under “Opportunities and targets”

Q4.1) Do you agree in treating opportunities as a voluntary content with the consequent adaptations in text of draft LSME ESRS compared to main ESRS?

Q4.2) For targets, do you agree to include them only to the extent that the undertaking has established targets?

With reference to paragraphs under “Definition of impact”

Q5) Do you agree to not include positive impacts in the draft LSME Standard?

With reference to paragraphs under “Qualitative characteristics of information”

Q6) Do you agree with this approach to i) avoid the reference to Appendix C ESRS1 and ii) provide a simplified redrafting of “qualitative characteristics of information” in the draft LSME ESRS? Do you think that the content of Set 1 Appendix C of ESRS 1 should anyway be mentioned as a further source of guidance?

With reference to paragraphs “Approach to the value chain”

Q7) For the area of policies, targets and actions, which role would you consider the collection of information from SMEs in the value chain will have?

Q8) To what extent would you consider that in order to be able to prepare its sustainability statements (limited to policies, actions and targets) an undertaking would in practice have to collect ad hoc information from the counterparties?

Q9.1) Would you consider that the information available as part of the internal management reporting are sufficient in order to produce the necessary disclosure?

Q9.2) Which additional simplifications could be considered for the value chain as compared to ESRS 1? Would such simplifications interfere with the possibility for the large undertakings to collect data from their own value chain counterparties that are SMEs (via the cap)?

(for instance introducing limitation to TIER 1 suppliers, thresholds, or considering the potential introduction of a new undue cost principle illustrated above, allowing to omit information when non reliable, allowing to omit information when collection is impracticable – knowing that the SR TEG and SRB has considered but rejected such simplifications when drafting Set 1)

With reference to paragraphs under “Approach to materiality”

Q10.1) Do you agree with the suggested approach that in the LSME ESRS the SFDR PAI, Benchmark and Pillar 3 related disclosures shall be introduced as “subject to materiality” on the assumption that this would not conflict with the possibility of large undertakings of requiring the same data to SMEs in their value chain?

Q10.2) Do you agree with the observations in paragraph 59 above? Do you agree that requiring to report SFDR indicators mandatorily (outside materiality assessment) in VSME would be disproportionate?

Q11) Future ESRS sector standards: to make them applicable also to SMEs? to what extent? What type of consultation questions could we ask to collect constituents views on this aspect? From a timeline perspective it would be after each ESRS sector standard.

Q12) Do you agree with the proposed approach to materiality in paragraph 61 above?

Q13) Do you think that in LSME there should be more space for materiality assessment (as this provides flexibility and so reduces the burden) or less space for materiality assessment (as the exercise of judgement result in the need to have more dedicated resources and more mature processes than the average situation in an SME)?

Q14) How such additional or reduced space could be operationalised?

List of DRs (Annex)

Q15) Do you have initial reactions to the list?