EUROPEAN FEDERATION
OF ACCOUNTANTS AND AUDITORS
FOR SMES

What SMPs and SMEs Need to Know About Sustainability Reporting

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Introduction

The European Commission ('the Commission') has announced its intention to overhaul the corporate reporting system in the European Union ('the EU') such that sustainability reporting will assume equal importance to that of financial reporting. In so doing corporate reporting will then be aligned with and support the EU's policy objectives including 'net zero' emissions, that is carbon neutrality. This presents a significant challenge and opportunity for small- and medium-sized accountancy practices (SMPs) and small- and medium-sized enterprises (SMEs). SMPs have a key role to play in helping SMEs prepare sustainability reports, just as they currently do financial reports, as well as providing assurance on these reports and advising SMEs more generally on the adoption of sustainable business practices. This report summarizes what SMPs and SMEs need to know about sustainability reporting.

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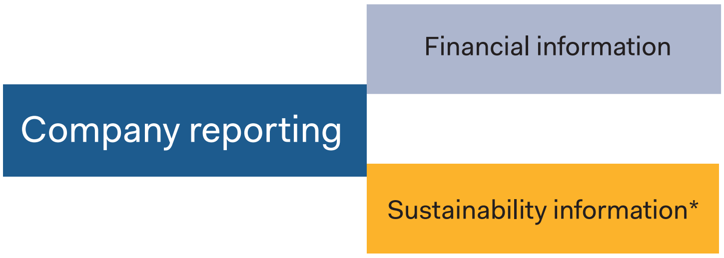
What European SMPs and SMEs Need to Know About Sustainability Reporting?



** Previously non-financial information*

What is sustainability reporting?

Presently EU law requires certain large companies to disclose information on the way they operate and manage social and environmental challenges. This sustainability information, until recently called non-financial information, includes information related to:

- environmental matters
- social matters and treatment of employees
- respect for human rights
- anti-corruption and bribery
- diversity on company boards (in terms of age, gender, educational and professional background).

This helps investors, civil society organisations, consumers, policy makers and other stakeholders to evaluate the non-financial performance of large companies and encourages these companies to develop a responsible approach to business.

Where can one find regulation on sustainability reporting?

Directive 2014/95/EU – also called the Non-Financial Reporting Directive (NFRD) – lays down the rules on disclosure of non-financial and diversity information by certain large companies. This directive amends the **Accounting Directive 2013/34/EU.**

- In June 2017 the Commission published its guidelines to help companies disclose environmental and social information. These guidelines are not mandatory and companies may decide to use international, European, or national guidelines according to their own characteristics or business environment.
- In June 2019 the Commission published guidelines on reporting climate-related information, which in practice consist of a new supplement to the existing guidelines on non-financial reporting, that remain applicable.

- On 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the NFRD. The Commission's proposal for CSRD envisages the adoption of EU sustainability reporting standards (ESRS). The draft standards will be developed by the European Financial Reporting Advisory Group (EFRAG). The standards will be tailored to EU policies, while building on and contributing to international standardisation initiatives. The first set of standards would be adopted by October 2022.

What about sustainability reporting requirements for SMEs? Are they obliged to report?

Under Directive 2014/95/EU SMEs are not required to report as they are not included in its scope. They can, however, disclose voluntarily.

Presently there is no EU requirement for SMEs to produce sustainability reports therefore those produced are on a voluntary basis. A number of internationally recognised frameworks are available for voluntary use including those of the Global Reporting Initiative (GRI) and the International Integrated Reporting Council (IIRC). While sustainability reporting is voluntary for SMEs, they may be required to produce sustainability information to satisfy the reporting obligations of providers of finance and to large customers in their value chain.

The proposed CSRD would extend the scope to all large companies and to all companies listed on EU regulated markets (except listed micro-enterprises). It would, therefore, include companies with between 250 and 500 employees. It would not, however, introduce any new reporting obligations on SMEs other than SMEs listed on EU regulated markets.

The Commission proposes to develop standards for large companies and separate, proportionate standards for SMEs. While SMEs listed on regulated markets would be required to use these proportionate standards, non-listed SMEs –representing the great majority of SMEs– may choose to use them on a voluntary basis.

The Commission believes that this proposal is proportionate, striking the right balance between meeting the needs of investors and other stakeholders for sustainability information from companies, and limiting the potential administrative burden for companies themselves.

What about external assurance on sustainability information? Are SMEs obliged to obtain assurance?

According to Directive 2014/95/EU Statutory auditors and audit firms only need to check that the non-financial statement, which may be in a separate report from the financial statements, has been provided by those companies that are within scope. In addition, Member States may also require that the information included in the non-financial statement be verified by an independent assurance services provider. For example, in Spain under Law 11/2018 assurance of sustainability statements is a compulsory requirement.

The proposed CSRD introduces a requirement for assurance on sustainability information. All companies within its scope will be required to obtain limited assurance on reported sustainability information, with an option to move towards a reasonable assurance requirement at a later stage.

This means that under proposed CSRD non-listed SMEs will not be obliged to obtain assurance on their sustainability reports. Rather only listed SMEs on European regulated markets are within its scope and so be required to report and obtain assurance thereon.

Who is permitted to provide external assurance on sustainability information?

Directive 2014/95/EU only establishes that a non-financial statement can be verified by an 'independent assurance services provider'.

The proposed CSRD allows Member States to allow any independent assurance services provider accredited in accordance with Regulation (EC) No 765/2008 of the European Parliament and of the Council to provide an opinion on sustainability reporting on the basis of a limited assurance engagement. It also requires Member States to ensure that consistent requirements are set out for all persons and firms, including statutory auditors and audit firms, who are allowed to provide the opinion on the assurance of sustainability reporting.

In effect the Commission's proposal allows Member States to open-up the market for sustainability assurance services such that Member States could chose to allow firms other than the usual auditors of financial information to provide assu-rance on sustainability information.

What standards must be used to report sustainability information?

Under Directive 2014/95/EU companies may rely on national frameworks, Union-based frameworks such as the Eco-Management and Audit Scheme (EMAS), or international frameworks such as the Global Reporting Initiative (GRI) and other recognised international frameworks.

Member States may currently have their own non-financial or sustainability reporting requirements which any reporting might need to comply with.

The proposed CSRD introduces the requirement to report in line with mandatory EU sustainability reporting standards. These standards have yet to be developed.

What standards must be used to report sustainability information by SMEs?

SMEs listed on regulated markets may choose use these simpler standards to meet their legal reporting obligations, while non-listed SMEs that have voluntarily chosen to produce a sustainability report may also choose to use them. These standards will be carefully adapted to the capacity of SMEs. This would make it easier for SMEs to report information to banks, large companies whom they supply and other stakeholders as well as help SMEs play a full role in the transition to a sustaina-ble economy.

In parallel to the new rules proposed for large companies, the Commission is also proposing the development of separate, proportionate standards for SMEs.

Who is going to develop the EU sustainability reporting standards?

EFRAG will be responsible for developing these draft standards. EFRAG is a private association established in 2001 and created with the encouragement of the Commission to serve the public interest. Majority financed by the EU, EFRAG relies on a public-private partnership model and its role has been to advise the Commission on the adoption of International Financial Reporting Standards (IFRS) into EU law. **EFAA for SMEs** are members of EFRAG and we actively participate in its projects and assemblies, being the voice of SMPs and SMEs on all relevant matters including sustainability reporting.

What will be the next steps? And the next steps for SMEs?

The next step is for the European Parliament, and the Member States in the Council, to negotiate a final legislative text on the basis of the Commission's proposal. In parallel, EFRAG will start work on a first set of draft sustainability reporting standards. These draft standards will then be ready for consideration by the Commission once the Parliament and Council have agreed a legislative text for the CSRD. EFRAG aims to have the first set of draft standards ready by mid-2022. The final timetable will depend on how the Parliament and Council progress in their negotiations. If they reach agreement in the first half of 2022, then the Commission should be able to adopt the first set of reporting standards under the new legislation by the end of 2022. That would mean that companies would apply the standards for the first time to reports published in 2024, covering financial year 2023.

The requirements for listed SMEs would apply only three years after they apply to larger companies, the additional time given due to the acute economic difficulties faced by smaller companies as a result of the COVID-19 pandemic.

It means that listed SMEs will be required to publish a report for the first time in 2027, covering financial year 2026.

Non-listed SMEs could start to voluntarily report in accordance with the proposed SME sustainability reporting standards as soon as the standards are adopted.

Where must the sustainability report be published?

Under Directive 2014/95/UE the non-financial statement shall be included in the management report or as a separate report corresponding to the same financial year made publicly available within a reasonable period of time, not exceeding six months after the balance sheet date, on the undertaking's website, and is referred to in the management report.

The proposed CSRD removes the possibility provided for in the NFRD for Member States to allow companies to report the required information in a separate report that is not part of the management report. Undertakings must therefore report sustainability information in the management report.

When must the sustainability report be published?

According to Directive 2013/34/EU and Directive 2014/95/EU, non-financial information refers to the financial year and is published in accordance with the requirements of financial information. When an undertaking prepares a separate report it must correspond to the same financial year and (a) is published together with the management report, or (b) is made publicly available within a reasonable period of time, not exceeding six months after the balance sheet date, on the undertaking's website, and is referred to in the management report.

The proposed CSRD establishes that Member States shall ensure that undertakings publish within a reasonable period of time, which shall not exceed 12 months after the balance sheet date, the duly approved annual financial statements and the management report, together with the opinions and statement submitted by the statutory auditor or audit firm.

What format must be used for sustainability reporting?

While Directive 2014/95/EU prescribes what information is to be disclosed it offers flexibility as to its format.

The proposed CSRD would require companies to prepare their financial statements and their management report in XHTML format and to 'tag' their reported sustainability information according to a digital categorisation system as and when specified in Regulation (EU) 2018/815 of 17 December 2018 supplementing Directive 2004/109/EC of the European Parliament and of the Council with regard to regulatory technical standards on the specification of a single electronic reporting format. This digital categorisation system will be developed together with the sustainability reporting standards. This will mean that sustainability information can easily be incorporated in the European Single Access Point envisaged in the Capital Markets Union Action Plan.

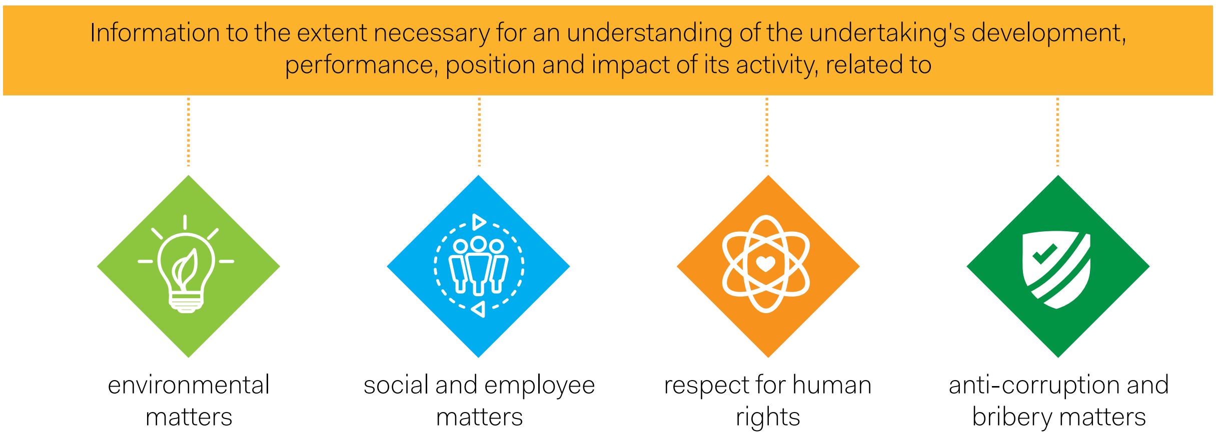
Who is responsible for the sustainability report?

Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings establishes that the members of the administrative, management and supervisory bodies of an undertaking should, as a minimum requirement, be collectively responsible to the underta-king for drawing up and publishing annual financial statements and management reports. The same approach should also apply to members of the administrative, management and supervisory bodies of undertakings drawing up consolidated financial statements. Those bodies act within the competences assigned to them by national law. This should not prevent Member States from going further and providing for direct responsibility to shareholders or even other stakeholders.

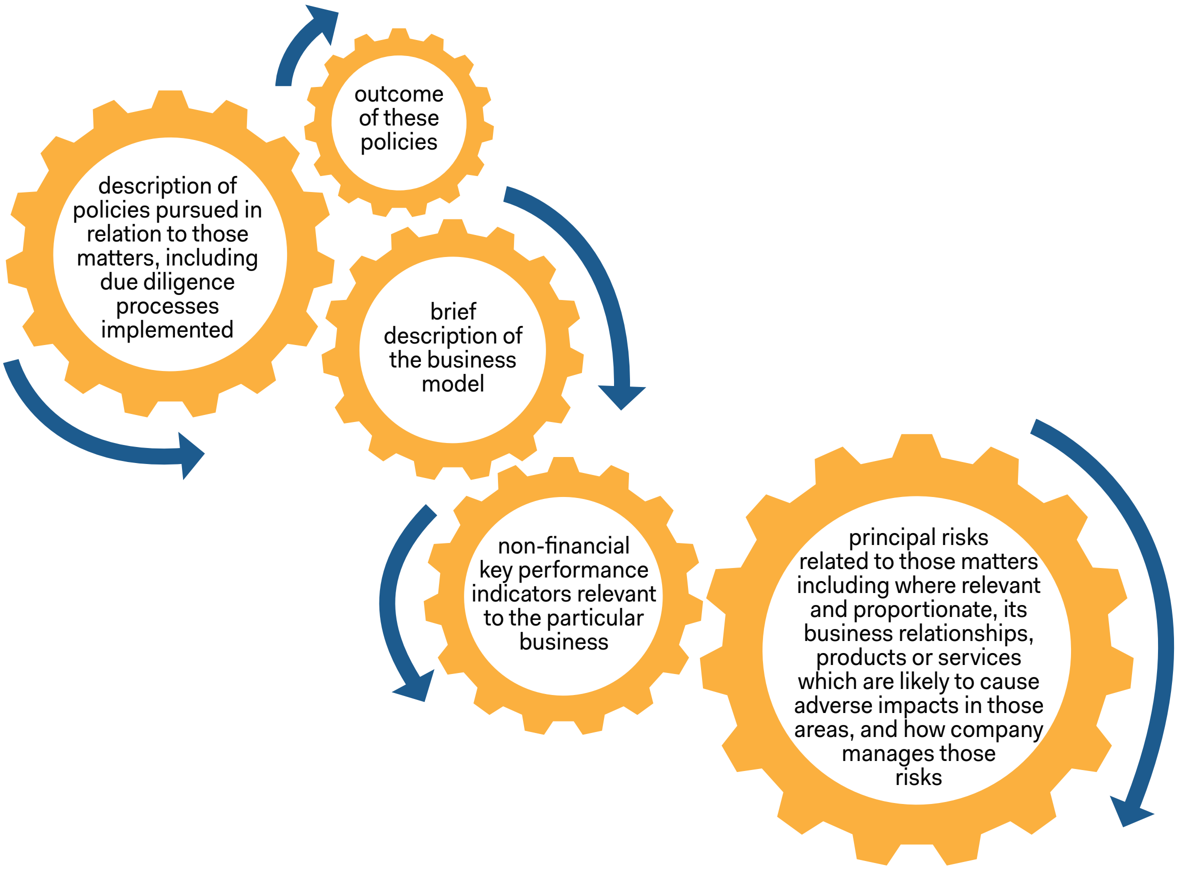
The proposed CSRD aligns the collective responsibility of the members of the administrative, management and supervisory bodies of a company with the new sustainability reporting requirements. In particular it requires administrative, management and supervisory bodies to ensure that the company in question has reported in accordance with EU sustainability reporting standards, and in the digital format required, and deletes the reference to the currently allowed se-parate report for sustainability reporting.

How to Prepare a Report

Non-financial information according to Directive 2014/95/EU must include the following:



(while this process and the topics will differ once the CSRD and the newly developed ESRS take effect, they nevertheless serve as a good initial basis for preparing a report)



Environmental matters

- current and foreseeable impacts of the company´s operations on the environment
- current and foreseeable impacts of the company´s operations on health
- current and foreseeable impacts of the company´s operations on safety
- use of renewable and/or non-renewable energy
- greenhouse gas emisions
- water use
- air pollution

Social and employee matters

- actions taken to ensure gender equality
- implementation of fundamental conventions of the International Labour Organisation
- working conditions
- social dialogue
- respect for the right of workers to be informed and consulted
- respect for trade union rights
- health and safety at work
- dialogue with local communities
- actions taken to ensure protection and the development of those communities

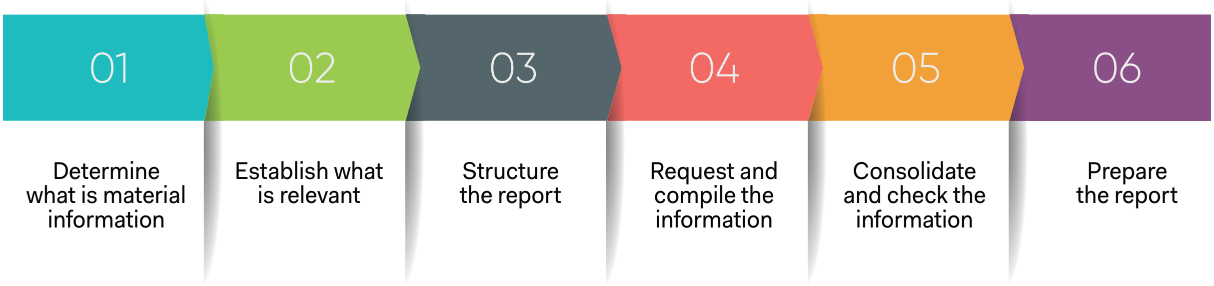
Respect for human rights

- prevention of human rights

Anti-corruption and bribery

- instruments in place to fight corruption and bribery

Follow these steps when preparing a report:



- **STEP 1. Determine what is material information** - one should determine in relation to the subject matter what will most likely bring about the materialisation of principal risks of severe impacts, along with those that have already materialised. The severity of such impacts should be judged by their scale and gravity. The risks of adverse impact may stem from the undertaking's own activities or may be linked to its operations, and, where relevant and proportionate, its products, services, and business relationships, including its supply and subcontracting chains. This should not lead to undue additional administrative burdens for small and medium-sized undertakings.
- **STEP 2. Establish what is relevant** - related to the materiality it is necessary to assess the relevance of the information and if it is not relevant to explain why it is not. That is, one should apply the "comply or explain" principle.
- **STEP 3. Structure the report** - prepare a table of contents and select indicators in accordance with recognized international standards. It is useful to compare with other non-financial reports.
- **STEP 4. Request and compile the information** - quantitative and qualitative information for each of the areas needs to be assembled. It may be necessary to interview to gather qualitative information.
- **STEP 5. Consolidate and check the information** - assemble the information according to the table of contents and check that the information has been correctly compiled.
- **STEP 6. Prepare the report** - prepare the report according to the table of contents. One may include an index of information in accordance with any recognized international standards used.
- **STEP 7. External verification / assurance** (where applicable) - obtain verification or assurance on the report.
- **STEP 8. Approval** (where applicable) - the report is signed by the administrators responsible for preparing the financial statements and the management report.
- **STEP 9. Publication** - publish the report on the company website and elsewhere as required.

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