Draft European Sustainability Reporting Standards: Overarching Comments by Shift

Shift welcomes the publication of the first draft set of European Sustainability Reporting Standards and commends the European Financial Reporting Advisory Group on producing a rich and important set of draft standards in a short period of time. While we are responding separately to a number of the survey questions circulated as part of the consultation process, we recognize that these do not allow for the full expression of views on the draft standards and therefore submit this letter also to complement our survey responses. In it we address issues related to:

1. **The architecture of the cross-cutting standards**

2. **The articulation of the materiality assessment process**
   a. Providing clarity on the central role of due diligence
   b. Focusing on the materiality process rather than 'rebuttable presumptions'.

3. **Alignment with international standards and the definition of value chains**

4. **The relevance of governance and business models to information on due diligence**
   a. Relevance of governance disclosures to alignment with due diligence standards
   b. Relevance of business models as source of impacts in the context of due diligence

5. **The significance of engagement with affected stakeholders**
   a. Value of clearly distinguishing affected stakeholders and their particular relevance
   b. Need for cross-cutting disclosures on engagement with affected stakeholders

6. **The value of the architecture of the social standards**
   a. Value of division into standards based on stakeholder group
   b. Need for performance metrics for all stakeholder groups in future standards

1. The architecture of the cross-cutting standards

Shift fully supports the ambition of the European Union and EFRAG to develop sustainability reporting standards based on double materiality and extending across all three areas of environmental, social and governance performance. As such they should, and will, go beyond the range and number of the standards being developed by the International Sustainability Standards Board (ISSB).

At the same time, there have been widespread and justified calls, including from within the European Parliament, for as much alignment as possible between the European sustainability reporting standards and those being developed by the ISSB. Indeed, the final text of the Corporate Sustainability Reporting Directive states that, 'European standards should reduce the risk of inconsistent reporting requirements on undertakings that operate globally by integrating the content of global baseline standards to be developed by the ISSB, to the extent that the content of the ISSB baseline standards is consistent with the EU's legal framework and the objectives of the European Green Deal'. Such alignment will be crucial to avoid introducing new and unnecessary confusion.

As such, the approach of having common 'building blocks' between the European standards and those of the ISSB is particularly important. This must start with the basic architecture of the standards and the related nomenclature. The ISSB has adopted the now well-established four-part structure of the Taskforce for Climate-Related Financial Disclosures (TCFD), consisting of governance, strategy, risk management, and targets and metrics. The fact that the draft EFRAG standards are based on a three-part structure of strategy, implementation and performance measurement is therefore unhelpful and unnecessary. The fact that linkages can be drawn between the respective categories in no way removes the fact that it creates a separate set of terms and ways of categorizing disclosures that makes it harder for companies to have a single, clear construct for navigating the respective requirements. There is no inherent difficulty in restructuring ESRS 2 and incorporating the disclosure principles from ESRS 1 to follow the same four-part framework used by ISSB, without any violence to the content of the current drafts. We strongly urge that this be done and attach an indication of the relative ease with which it could be achieved at Annex A.

2. The articulation of the materiality assessment process

a. Providing clarity on the central role of due diligence

The CSRD states that information to be reported shall include:

> *"a description of:*
> *(i) the due diligence process implemented by the undertaking with regard to sustainability matters, and where applicable in line with EU requirements on undertakings to conduct a due diligence process;*
> *(ii) the principal actual or potential adverse impacts connected with the undertaking's own operations and with its value chain, including its products and services, its business relationships and its supply chain, actions taken to identify and track these impacts, and other adverse impacts which the undertaking is required to identify according to other EU requirements on undertakings to conduct the due diligence process;*
> *(iii) any actions taken by the undertaking, and the result of such actions, to prevent, mitigate, remediate or bring an end to actual or potential adverse impacts;"*

This understanding of the key elements of due diligence is drawn from the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises, with which the CSRD requires that the reporting standards be consistent.

The concept of due diligence is introduced in section 2.5 of ESRS 1 as the fifth of five concepts drawn from the CSRD. It indicates that a summarized explanation of due diligence is provided in Appendix C, notes that the reporting standards provide disclosure requirements concerning the main aspects of due diligence and indicates where those disclosures can be found.

Finally, disclosure Requirement 2 – IRO 1 on the '*Description of the processes to identify material sustainability impacts, risks and opportunities'* asks companies to report:

> *"a description of the methodologies adopted and of the processes implemented for the [materiality] assessment, including the related internal control procedures and the decision-making steps, through i. an overview of the due diligence process used to identify and assess potential and actual impacts on the environment and people connected with the undertaking […]'*

As a result of this approach to due diligence in the text of the cross-cutting standards, a complete view of due diligence can only be seen in an appendix, and companies unfamiliar with the process on the one hand find related disclosures dispersed through the standards and on the other hand might infer that due diligence is primarily about materiality assessment. This lack of structure and logic to how due diligence is presented in the texts sows unnecessary confusion.

We would therefore recommend that the text of ESRS 1 set out clearly:

a. that the process of due diligence is established in the two international standards of the UN Guiding Principles and the OECD Guidelines as part of all companies' responsibilities with regard to actual or potential impacts on human rights and the environment that are connected to their operations, products or services through their own activities or by their business relationships;
b. a brief overview of the key steps of due diligence (similar to para 86 of ESRS 1) and that the full due diligence process is summarized in the appendix, which should be used by preparers as a guide to understanding the context and intent of related disclosures;
c. that due diligence is an on-going process related first and foremost to companies' *own management of these impacts,* with the aim of effectively preventing, mitigating and remediating them
d. that the first step of due diligence – the identification and assessment of actual or potential negative impacts, including, where necessary, the means of prioritizing action to address those impacts – is also the basis for identifying and prioritizing the impacts that will be material for the purposes of a company's reporting under the 'impact' aspect of double materiality, as set out further set out in disclosure requirement IRO 2-01;
e. the other disclosures in the cross-cutting standards that reflect aspects of due diligence (similar to paras 87 to 91 of ESRS 1)

This approach should better enable preparers to orient themselves with regard to what due diligence is about, how it relates to the materiality assessment process, and how it relates to other disclosures.

b. Focusing on the materiality assessment process rather than 'rebuttable presumptions'.

Materiality determination is the cornerstone of an effective and meaningful sustainability reporting process, guiding preparers and users to the ESG topics, issues and data which are relevant in order to understand the risks, opportunities and impacts of a company.

A materiality assessment process is not solely relevant to reporting but should be reflective of an understanding of impacts, risks and opportunities that are integrated into the entity's strategy, risk management systems, policies, processes and plans. The materiality assessment process should support internal cross-departmental discussions, including at a senior level, that enable coherent action throughout the year. It is least effective when treated in a tick-box manner and seen as being of relevance solely to reporting and those in the company who deal with reporting.

However, the way in which the concept of the ‘rebuttable presumption’ is used in the standards promotes such a tick-box approach. It implies that companies should first look at the mandatory disclosures and determine whether they have a basis for judging any of them not to be material for the company.

The standards should not take this approach. Rather – in line with standard practice – the starting point should be the company’s own materiality assessment. The ESRS should include guidance on the appropriate process to be followed, as part of which companies should be guided to consider carefully the full array of sustainability issues that may be material from both an impact materiality and financial materiality perspective. Companies should be explicitly guided to review all topics and sub-topics in the ESRS to stress-test their assumptions regarding potential material issues.

It is only after this assessment process has been conducted that the company might then have the evidence base to determine whether any of the mandatory ESRS are, or are not, material in light of its own circumstances. The concept of a rebuttable presumption might be used but is not necessary in explaining that where the materiality process demonstrates a mandatory standard not to be material for the company, it should then make a statement to that effect. Where that conclusion relates to an entire sub-topic or sub-sub-topic, the standards should seek a brief explanation of that conclusion.

Shift therefore recommends that the focus on the ‘rebuttable presumption’ be removed and the process of materiality assessment be given primacy, with more comprehensive, cross-cutting guidance and more detailed disclosure requirements, in particular guiding companies to take into account in their assessment all sub-topics covered by the ESRS.

Shift also recommends that the standards make clear that the cross-cutting disclosure requirements in ESRS 2 are not subject to a materiality assessment, but are relevant information for all companies to disclose. We also support the recommendation of GRI that disclosures related to workforce composition (employees and non-employee workers in the workforce) and the extent of coverage of freedom of association, be included in these cross-cutting disclosures (rather than their current location in S1), as they constitute basic, relevant information about any organization, and should not be subject to a materiality assessment.

3. Alignment with international standards and the definition of value chains

Overall, the draft standards do a good job of aligning with the key international standards of the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises. That said, there are a few minor drafting points that should be corrected for, mostly captured in comments provided by GRI, and which we will highlight separately. However, there are broader issues arising with regard to how the value chain is defined and articulated throughout the cross-cutting drafts, which affect both consistency of interpretation and alignment with the international standards.

Appendix A to ESRS 2 defines the 'value chain' of an undertaking as:

> *'The full range of activities or processes needed to create a product or service. This includes entities with which the undertaking has a direct or indirect business relationship, both upstream and downstream of its own activities, which either (a) supply products or services that contribute to the organisation's own products or services, or (b) receive products or services from the organisation.'*

This definition would imply that the value chain is viewed as separate from a company's own operations, which matches with the language of the international standards of the UN Guiding Principles and the OECD Guidelines, which refer to a company's 'operations and value chain'. It is supported by the language used in para 72 of ESRS 1 when it states, ' In addition to the distinction between information in relation to its own operations and information in relation to its downstream and upstream value chain, the undertaking shall consider all relevant facts and circumstances, in defining the appropriate level of disaggregation for information in sustainability reports.' Similar clarity appears in other paragraphs such as 97b, 100c and 104b.

However, paragraph 66 of the Application Guidance to ESRS 2, diverges from this clarity when it states that, 'a negative impact is "directly linked to" the undertaking's operations, products or services, if it occurs at any tier of business relationships ***provided it occurs as part of the value chain***, and it is not restricted to most obvious links between the undertaking and the other entity, and is therefore not limited for instance to direct contractual relationships, such as 'direct sourcing' [emphasis added]' This would imply that direct linkage cannot pertain to business relationships that are not part of the value chain. Based on the definition provided, this would include, for example, relationships with public or private security providers at a mine or third party employers of cleaning staff at a company's facilities, that would not be understood to contribute to products or services. It would also include relationships with JV partners, which are neither 'upstream' or 'downstream'. The same issue arises in para 50 of ESRS 1 when it states that, 'An impact is 'directly linked to' the undertaking's operations, products or services, if it occurs in relation to any tier of business relationships, **provided in the value chain** [emphasis added],' and in para 49 when it states that, 'This includes impacts directly caused or contributed to by the undertaking in its own operations, products or services and impacts which are otherwise directly linked to the undertaking's upstream and downstream value chain'.

Paragraph 24 (c) of ESRS 1 refers to, 'Material actual or potential (adverse) impacts, risks and opportunities connected with the undertaking's value chain, including its products and services, its business relationships and its supply chain', which confusingly mixes up supply chain and value chain along with products and services and then business relationships, and leaves it unclear where 'operations' would fit in.

In addition, the language of both Para 44a of ESRS 1 and the definition of stakeholders in that standard confusingly introduce the language of activities alongside value chains. Both refer to affected stakeholders as, 'individuals or groups that have interests that are affected or could be affected – positively or negatively – by the undertaking's activities and through its value chain'.

These variations should be corrected to align with the international standards regarding the nature and extent of companies' responsibilities with regard to impacts on people and the environment. The international standards recognize that impacts may occur through a company's activities or through its business relationships. More specifically:

- It may **cause or contribute** to negative impacts **through its own activities**;
- **Impacts may be directly linked to its operations, products or services by its business relationships** (that is, without cause or contribution on the part of the company concerned);
- Business relationships include, 'relationships with **business partners, entities in its value chain, and any other non-State or State entity directly linked to its business operations, products or services**.'

In general, Shift strongly recommends that the term be kept separate from the term 'operations' and that the terms be used together to denote the full scope of due diligence and materiality assessments, as in the international standards. Paragraph 74 in IRO-1 regarding the disclosure of the processes to identify material sustainability impacts, risks and opportunities sets a good model when it calls for:

> *'an overview of the due diligence process used to identify and assess potential and actual impacts on the environment and people connected with the undertaking, including the extent to which these involve (1) reviewing the undertaking's own activities and its business relationships across its operations and value chain and (2) assessing both impacts the undertaking may cause or contribute to through its own actions and decisions, and impacts that may be directly linked to its operations, products, or services by business relationships.'*

4. The relevance of governance and business models to information on due diligence

Shift welcomes the appropriate and important connections made in the draft standards between governance and material impacts on the one hand, and between business models and material impacts on the other – the two, of course, being integrally related.

a. Relevance of governance disclosures to alignment with due diligence standards

We welcome that Disclosure Requirement 2-Gov 2 of ESRS 2 requires companies to describe how their governance bodies are informed about sustainability matters, including material impacts and the effectiveness of policies, targets and actions adopted to address those impacts, as well as, 'steps of due diligence standard processes that the undertaking is following on a mandatory and/or voluntary basis'. Given that the effective management of material impacts and risks is not possible without the proper involvement and oversight of governance structures, information regarding whether and how these structures engage with the issues is necessarily relevant and important to the users of reporting.

b. Relevance of business models as source of impacts in context of due diligence

We welcome also Disclosure Requirement 2-SBM 3 of ESRS 2, which requires companies to describe the interaction between their material impacts and their strategy and business model, including, 'how actual and potential material sustainability impacts originate from or are connected to the undertaking's strategy and business model(s)'. This marks an important step in addressing a gap in most current reporting frameworks and standards. While reporting standards have paid attention to how climate change can impact companies' business models, and how the business models of certain industries (notably the fossil fuel industry) can impact the planet, they have largely ignored the ways in which business models can impact people. Shift's work on human rights risks in business models[1] has demonstrated the range and extent of connections between business models and human rights risks, which cannot be properly addressed without the engagement of senior leadership and the board (hence creating a link back to the importance of governance disclosures). Companies need to understand these linkages to business models in order to conduct an effective materiality assessment. Users of reporting need this information in order to assess the appropriateness of any actions reported to address such impacts.

5. The significance of Engagement with Affected Stakeholders

a. Value of clearly distinguishing affected stakeholders and their particular relevance

Shift welcomes the clarity with which the draft standards articulate the distinction between affected stakeholders on the one hand, and stakeholders who are users of sustainability reporting on the other, while recognizing that some, but not all, stakeholders may belong to both groups. We welcome also the clarification in ESRS 1 that, 'The materiality assessment process should ensure that impact on all affected stakeholders is considered and not only the needs of users'.

In relation to our earlier recommendation that the standards should make clearer the relationship between due diligence and the assessment of impact materiality, it should be particularly clear that engagement with affected stakeholders is central to due diligence and not something to be preserved for a materiality assessment. Indeed, a materiality assessment may be the least appropriate moment at which to solicit the views and experiences of many affected stakeholders – particularly those outside the workforce – whose interest is primarily in the company's conduct in their particular context, rather than in its generic reporting practices (see further below). The materiality assessment process can be better suited to engagement with representatives of affected stakeholders such as trade unions, and with NGOs, academics and other experts. They are well-placed to the more generalized, corporate-level task of helping the company stress-test its conclusions regarding materiality in light of the findings of its various on-going due diligence processes.

b. Need for cross-cutting disclosures on engagement with affected stakeholders

Shift notes that beyond this helpful recognition of the unique status of affected stakeholders in ESRS 1, the disclosure requirements in ESRS 2 do not acknowledge the central role of *engagement* with affected stakeholders. Engagement with affected stakeholders underpins the entire practice of due diligence, informing both a proper understanding, and the effective management, of impacts. Information about how a company approaches engagement with these stakeholders is therefore of central relevance to understanding the likelihood that material impacts are being adequately identified, understood and addressed, and should be a part of disclosures.

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[1] https://shiftproject.org/resource/business-model-red-flags/red-flags-about/

ESRS 2 includes disclosures regarding the 'views, interests and expectations of stakeholders' only in relation to the undertaking's business model and strategy – a level at which affected stakeholders rarely engage with the company. Moreover, it asks for a description of stakeholders and their views, interests and expectations 'as analyzed during the undertaking's own materiality assessment process'. However, as noted above, steps to understand the critically important views of affected stakeholders should be integral to on-going *due diligence* and not part of an annual materiality process focused on public disclosure requirements.

It is appropriate that specific modes of engagement with affected stakeholders be disclosed in relation to specific types of stakeholder, as reflected in social disclosures S1 to S4. However, the cross-cutting standards should include one or two general disclosure requirements on how an undertaking identifies its key stakeholders – including, specifically, affected stakeholders – in relation to impacts, risks and opportunities, and not just in relation to its strategy and business model, and on the company's general approach to engagement with affected stakeholders as part of its due diligence.

Beyond these general disclosures on stakeholder engagement, Shift supports the approach that more specific information on how the views of affected stakeholders shape action and the assessment of its effectiveness sit most appropriate at the level of sub-topics. We support, therefore, the inclusion of such disclosures as they appear in the social standards in relation to an undertaking's own workforce, value chain workers, affected communities and end-users/consumers.

6. The value of the architecture of the social standards

a. Value of division into standards based on stakeholder group

Shift welcomes the clear architecture introduced in the social standards S1 to S4. The standards avoid pitfalls seen elsewhere of leaping straight to a list of topics that are often very varied in type, ranging from categories such as 'labor standards' or 'human capital' to specific impacts such as 'forced labor' or 'privacy' to groups such as 'indigenous peoples' to processes/functions such as 'supply chain management' or 'responsible marketing'. This kind of unstructured, mixed bag of topics makes it hard for any organization to understand what is included and why, and how to orient their own working realities to the issues concerned.

It is therefore very helpful that the social standards offer a clear model for any company to understand the range of potential social issues and how they may become relevant and material for their own organization. The structure recognizes that social issues are fundamentally about people, as individuals or as groups. The key categories of people reflected in the structure of the standards are workers in a company's own workforce, workers in its value chain, communities affected by its operations or value chain, and people affected by its products or services (consumers, end-users and others). Companies can then consider and anticipate the distinct types of impact that each stakeholder group is more likely to encounter in relation to that company's operations and value chain. For example, workers can face impacts related to wages and working hours while their consumers are unlikely to do so. Affected communities are more likely to face impacts related to land use than are value chain workers.

The structure also allows us more easily to see that the same category of impact may affect different stakeholder groups but do so differently and warrant different disclosures as a result. For example, a workforce may face health and safety impacts in the workplace, with regard to which a company can provide granular disclosures on the measures it has in place to prevent and address harm. Workers in the value chain can face the same impacts but disclosures will necessarily be less quantitative and precise due to issues of access to data, as well as different expectations for action where an impact is not caused by the company. Communities can face health and safety impacts as well, but in different ways – for example when communities near agricultural fields being sprayed with pesticides face health impacts from the chemicals used, or communities near a mine find the safety of their houses undermined by blasting. And consumers of course may face health or safety impacts due to ingredients in a product, design of a product, or misuse of a service such as a social media platform. The kind of differentiation in disclosures necessary to reflect these wide variations in how a topic arises becomes much easier when disclosures are broken out by stakeholder group.

b. Need for performance metrics for all stakeholder groups in future standards

Shift recognizes the need to limit standards in the first set produced by EFRAG to those most likely to be material to all companies, and supports the initial focus of performance metrics on the ‘own workforce’ of an undertaking, as seen in S1. However, we urge EFRAG to ensure that the next set of draft standards, particularly focused on sector-specific standards, should include performance-related disclosures with regard to value chain workers, affected communities and users of products and services. We suggest that an open mind be kept as to whether some of these should appropriately be sector-agnostic disclosures, in particular with regard to value chain workers. The structure established din this first set of standards will enable appropriate tailoring of such disclosures according to the relevant stakeholder group as well as the type of impact concerned.

ANNEX A:
ESTABLISHING A SHARED BASIC STRUCTURE AND TERMS ACROSS EFRAG AND ISSB

The following provides a basic depiction of how the disclosure requirements in ESRS 2, combined with the three disclosure principles in ESRS 1, could readily be brought together in the same structure, and with the same categories, as are used in the ISSB exposure drafts. This would provide the right and necessary basis for an approach of common 'building blocks' across ISSB and EFRAG standards, while leaving EFRAG free to continue to build and expand on these beyond the scope of ISSB's aims. This approach would be in line with call in the 'Corporate Sustainability Reporting Directive for European standards to 'reduce the risk of inconsistent reporting requirements on undertakings that operate globally by integrating the content of global baseline standards to be developed by the ISSB, to the extent that the content of the ISSB baseline standards is consistent with the EU's legal framework and the objectives of the European Green Deal.'

ISSB	EFRAG	Commentary on alignment
Governance	GOV-1 GOV-2 GOV-3 GOV-4 GOV-5	'Governance' already maps neatly across the two standards
Strategy	IRO-2 and IRO-3 SBM-1 SBM-2 SBM-3 SBM-4	It would be logical to start the 'Strategy' section of ESRS 2 with the IRO disclosures on what the undertaking's material issues are. This gives essential context for understanding the following SBM disclosures, which are about the relationship between the IROs and the undertaking's strategy and business model.
Risk Management	IRO-1 Disclosure Principle-1-1 Disclosure Principle-1-3	The third IRO disclosure fits appropriately in the risk management section, since it reflects the process for the identification of IROs. It makes sense to bring the two disclosure principles on policies, actions and resources into ESRS 2, which to the management of the identified impacts, risks and opportunities. The disclosure principles are distinct from the disclosure requirements in that they provide guidance to undertakings where standards have not yet been defined by EFRAG, and should be used alongside topic-specific standards where they do exist. This exactly mirrors the approach of the ISSB General Requirements draft standard.
Targets and Metrics	Disclosure Principle-1-2	The disclosure principle on targets, progress and tracking effectiveness aligns well with the category of 'targets and metrics'.