Summary of the voluntary sustainability reporting standard for non-listed SMEs under the Corporate Sustainability Reporting Directive (CSRD)

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EFRAG educational video series on SME standards:

EFRAG produced educational videos explaining their exposure drafts (ED) on sustainability reporting standards for listed SMEs (LSME) and non-listed SMEs (VSME). The videos can be watched on EFRAG's **YouTube channel**.

Background:

The EU's Corporate Sustainability Reporting Directive (CSRD) mandates sustainability reporting for listed companies, aiming to improve transparency and comparability of environmental, social, and governance information, facilitating sustainable investment decisions. Companies subject to the CSRD will have to report according to European Sustainability Reporting Standards (ESRS).

The European Financial Reporting Advisory Group (EFRAG) is mandated to draft the reporting standards. On 22 January, EFRAG launched a public consultation on two new sustainability reporting standard drafts for SMEs as part of the CSRD. One draft focuses on listed SMEs, while the other addresses non-listed SMEs, with the public consultation deadline set for 21 May 2024.

Non-listed SMEs are not mandated to report under CSRD. However, they still need to meet the data demands from business partners in their value chain, investors, and lenders. Therefore, the voluntary sustainability reporting standard is tailored to simplify SMEs' disclosures, serving as an alternative to multiple questionnaires coming from all business partners.

The EU's goal is to make sustainability reporting accessible and meaningful for SMEs, enabling them to participate in the transition to a sustainable economy. It also seeks to address data demands from business partners reporting under the CSRD and the Sustainable Finance Disclosure Regulation (SFDR), while minimising their reporting burden.

Why does it matter to the Impact ecosystem?

Impact Europe uncovered significant barriers to the sustainability reporting of non-listed SMEs in the context of our "**Survey Report - Experience of Impact Funds with SFDR**", conducted in mid-2023. This issue significantly affected impact asset managers seeking to collect data for their reporting obligations under SFDR's Article 9 for sustainable products. It imposed a heavy burden on both them and their investee companies, predominantly composed of non-listed, illiquid, small, and micro-impact enterprises. In response to these challenges, Impact Europe is conducting an assessment of the strengths and weaknesses of the proposed EFRAG's voluntary sustainability reporting standards for non-listed SMEs, with a specific aim to incorporate the perspectives of the impact ecosystem.

Summary of the voluntary sustainability reporting standard for non-listed SMEs:

The VSME ED, a voluntary sustainability reporting standard draft for non-listed SMEs, is sector-agnostic and covers the same sustainability issues as the European Sustainability Reporting Standards (ESRS) for large enterprises. It is based upon the key concept of proportionality, meaning it considers the fundamental characteristics of micro-, small- and medium-sized enterprises. For example, micro-enterprises have the flexibility to use only certain parts of the standard.

Key principles for preparing the sustainability report[1]:

- The principle of **double materiality** requires businesses to disclose how their operations impact negatively people and the environment, and how environmental and social issues affect their financial performance. Depending on the business activities, additional information beyond the standard may be necessary to address sector-specific issues.
- If a company is the parent of a group, it is suggested that it prepares its sustainability report by **consolidating information** from its subsidiaries.
- **Timing**: The sustainability report shall be prepared on an annual basis. It shall be available for issuance at the same time as the financial statements if they are prepared.
- The draft standard allows businesses to **omit to disclose classified or sensitive information** on intellectual property, know-how, or results of innovation, even if it is considered material, revealing it could harm the company financially, or the information holds commercial value.

Three reporting modules

This standard provides three reporting modules tailored to the diverse needs and capacities of non-listed SMEs.

[1] p.6-7

1. Basic Module

- Entry-level module for all non-listed SMEs.
- Targets micro-undertaking reporting and provides minimum reporting requirements for other non-listed SMEs.
- Materiality assessment is not needed, SMEs should report all data points when applicable to their circumstances.

2. Narrative-Policies, Actions and Targets (PAT) Module

- Recommended for SMEs at a more advanced sustainability stage which have PAT processes in place.
- The PAT module provides necessary context on data reported.
- Double materiality assessment needed.

3. Business Partners (BP) Module

- Recommended for SMEs responding to sustainability data requests from investors, lenders, and business partners.
- Double materiality assessment needed.
- Disclosures reflect CSRD and SFDR reporting requirements.

The Basic module serves as the starting point for all SMEs, with the flexibility to select additional modules when necessary. For instance, the company can report only the Basic module, the Basic and PAT modules, the Basic and BP modules, or all three modules.

Double Materiality Analysis for modules 2 and 3[2]:

In the VSME ED, the Narrative-PAT and Business Partners Modules require assessing the materiality of sustainability matters as essential information to be reported for data users.

Principles of materiality:
Materiality analysis is necessary to determine which sustainability issues are relevant for a business. It involves identifying matters that should be reported on, considering both impact materiality and financial materiality.
The draft Standard suggests using the list of sustainability matters in Appendix B as a guide for this identification process. Double materiality analysis entails assessing impacts on people and the environment, as well as financial risks and opportunities arising from sustainability matters.

[2] p. 13-14

Assessing Impact Materiality

Impact materiality determines the reporting of sustainability issues based on their actual and potentially significant effects on people, the environment, and business operations. The severity of negative impacts is assessed by considering the scale, scope, and remediation potential, guiding undertakings in analysing impact severity. *The company doesn't have to report on each of the three aspects but should consider them in the impact materiality analysis.*

When assessing **potential impacts**, the company must consider both severity and likelihood. Severity outweighs the likelihood of potential negative impacts on human rights. Quantitative measures provide objective evidence for assessing materiality, but qualitative analysis may suffice when quantitative data is unavailable or costly to obtain.

Assessing Financial Materiality

Financial materiality pertains to sustainability issues that could significantly impact a company's finances, including its position, performance, cash flows, access to finance, and cost of capital. This encompasses risks and opportunities from both the company's operations and its relationships with other firms. Material impacts and risks, both related and unrelated to the company's operations, should be considered. Assessing the probability and potential magnitude of financial effects helps determine material financial risks.

Reporting on financial opportunities is optional.

Basic Module[3]:

The companies shall report on their environmental, social, and business conduct issues using the B1 - B12 disclosures below. **Materiality analysis is not required**, but disclosures B1 to B12 should be provided **if relevant** to the company's circumstances. In the upcoming years of reporting, companies will be required to disclose comparative information from the previous year.

Disclosure B 1 – Basis for preparation

Disclosure B 2 – Practices for transitioning towards a more sustainable economy

- Disclosure B2 pertains to outlining specific practices aimed at transitioning toward a more sustainable economy - excluding philanthropic activities. These practices involve efforts to mitigate negative impacts and enhance positive ones on people and the environment. *This disclosure does not apply when the undertaking prepares its sustainability report using the Narrative-PAT Module.*

B3 -B12 provides for environmental, social and business conduct **basic metrics**. The undertaking may complement the metrics with additional qualitative and/or quantitative information if wishing to provide more comprehensive information.

[3] p.8-12

Basic Metrics – Environmental matters

- B 3 – Energy and greenhouse gas emissions
- B 4 – Pollution of air, water and soil
- B 5 – Biodiversity
- B 6 – Water
- B 7 – Resource use, circular economy and waste management

Basic metrics – Social matters

- B 8 – Workforce – General characteristics
- B 9 – Workforce – Health and safety
- B 10 – Workforce – Remuneration, collective bargaining and training
- B 11 – Workers in the value chain, affected communities, consumers and end-users

Basic metrics – Business conduct

- B 12 – Convictions and fines for corruption and bribery

Narrative-Policies, Actions and Targets (PAT) Module[4]:

This module defines narrative disclosures concerning Policies, Actions, and Targets (PAT), which are to be reported in addition to Basic Module disclosures if the undertaking has them in place. *This module is suggested for undertakings that have formalised and implemented the PAT.*

The SMEs Standard mandates a materiality analysis (see more below) to identify important sustainability matters from *Annex B list*. This helps users discern areas where the SMEs lack Policies, Actions, and Targets (PAT) and simplifies reporting by only requiring disclosure of the PAT that the undertaking has in place. No information is needed when there are no PATs for a material matter. See the disclosure requirements below.

Disclosures[5]:

- ***Disclosure N 1*** – *Strategy: business model and sustainability-related initiatives*
    - Revealing essential aspects of its strategy and business model, including sustainability factors, products or services offered, market presence, and business relationships such as suppliers and customers.
- ***Disclosure N 2*** – *Material sustainability matters*
    - The company should disclose sustainability matters identified through materiality analysis, including their impact on people or the environment, current and future financial effects, and influence on company activities and strategy.
- ***Disclosure N 3*** – *Management of material sustainability matters*
    - Disclosure of adopted policies or actions to address actual or potential negative impact and/or financial risks.

[4] p.12-16
[5] p.15-16

- ***Disclosure N 4*** – *Key stakeholders*
  - Disclose the nature of interactions with stakeholders, specifying the categories involved and the activities associated with them.
- ***Disclosure N 5*** – *Governance: responsibilities in relation to sustainability matters*
  - The company should outline its governance structure and responsibilities regarding sustainability issues, including the roles and duties of the highest governance body or individuals overseeing sustainability management within the company, where applicable.

Business Partners (BP) Module[6]:

This module sets data points to be reported in addition to disclosures of the basic module. In essence, the BP module outlines those data points which are likely to be included in data requests from lenders and investors to fulfil obligations of financial market participants under EU regulations, such as the Sustainable Finance Disclosure Regulation (SFDR). This information may also be requested by corporate clients and business partners reporting on the sustainability profile of their value chain under the Corporate Sustainability Reporting Directive (CSRD). Companies shall disclose the material sustainability matters resulting from their materiality analysis based on the list of sustainability matters provided in Appendix B.

Disclosures:

- **Disclosure BP 1** – Revenues from certain sectors
- **Disclosure BP 2** – Gender diversity ratio in governance body
- **Disclosure BP 3 –** GHG emissions reduction target
- **Disclosure BP 4** – Transition plan for climate change mitigation
- **Disclosure BP 5** – Physical risks from climate change
- **Disclosure BP 6** – Hazardous waste and/or radioactive waste ratio
- **Disclosure BP 7** – Alignment with internationally recognised instruments
  - Disclosure on whether policies pertaining to its own workforce are aligned with relevant internationally recognised instruments, including the UN Guiding Principles on Business and Human Rights.
- **Disclosure BP 8** – Processes to monitor compliance and mechanisms to address violations
  - Disclosure on whether the SME has processes in place to monitor compliance with the OECD Guidelines for Multinational Enterprises and with the UN Guiding Principles on Business and Human Rights, including the principles and rights set out in the International Bill of Human Rights and the eight fundamental conventions identified in the ILO Declaration or grievance/complaints handling mechanisms, to address violations of the above standards with regard to its own workforce.
- **Disclosure BP 9** – Violations of OECD Guidelines for Multinational Enterprises or the UN Guiding Principles (including the principles and rights set out in the eight fundamental conventions of the ILO Declaration and the International Bill of Human Rights)
- **Disclosure BP 10** – Work-life balance
- **Disclosure BP 11** – Number of apprentices

[6] p. 17-19

➔ The SMEs Standard has a **guidance section** dedicated to the Basic Module (p.20-35) and Business Partners Module (p.36-38) intended to support the preparation of the metrics for reporting.

Next Steps:

While non-listed SMEs fall outside the scope of the CSRD, they are encouraged to use this standard for preparing and disseminating sustainability information to relevant stakeholders. This draft, while lacking legal authority, provides undertakings beyond the CSRD's scope with a voluntary tool for sustainability reporting.

Investors, lenders, and business partners can already begin requesting this information, and non-listed SMEs can start using the standard. If you find the standard beneficial, you may begin implementation immediately.

The sustainability report should be prepared on an annual basis and be available for issuance at the same time as the financial statements, if available. However, it is worth noting that following the EFRAG consultation deadline in May 2021, the standard may undergo slight adaptations based on stakeholder recommendations.