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White Paper

Future Proofing Financial Reporting For Sustainability

What business needs to know on sustainability financial reporting including preparing for the ISSB, CSRD, EU Taxonomy and SFDR.

Davy Horizons. **Helping you define sustainable solutions.**

Contents

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Key takeaways

A tsunami of requirements impacting how business and finance disclose their performance on sustainability across all ESG verticals is inbound.

The EU Sustainable Finance Action Plan and Taxonomy of sustainable market activities is driving a transition to sustainable capital markets. The SFDR is already driving financial market participants to invest in these. From 2024, the CSRD is mandating corporations to report their progress across ESG to demonstrate progress aligned to best practice benchmarks.

Sustainability disclosure and reporting for capital markets is changing and increasingly tied to access to cheaper capital.

Globally, the International Sustainability Standards Board (ISSB) expects to finalise sustainability and climate-related risks disclosure standards required in financial reporting in 2023.

New templates, tools and digitisation of reporting will drive data quality improvements, enable comparison and help to avoid greenwash.

The Non-Financial Reporting landscape is changing and proactive corporates are in the process of assessing the scope and applicability of the ESG disclosures requirements so that they can develop the requisite reporting strategy and data gathering processes.

This insight explores the current non-financial reporting and sustainability disclosure landscape across ESG verticals. Emerging data requirements, tools and templates being used to streamline reporting are outlined. To get prepared, top tips give a blueprint for how corporates can future proof for incoming reporting requirements.

The EU sustainability reporting landscape

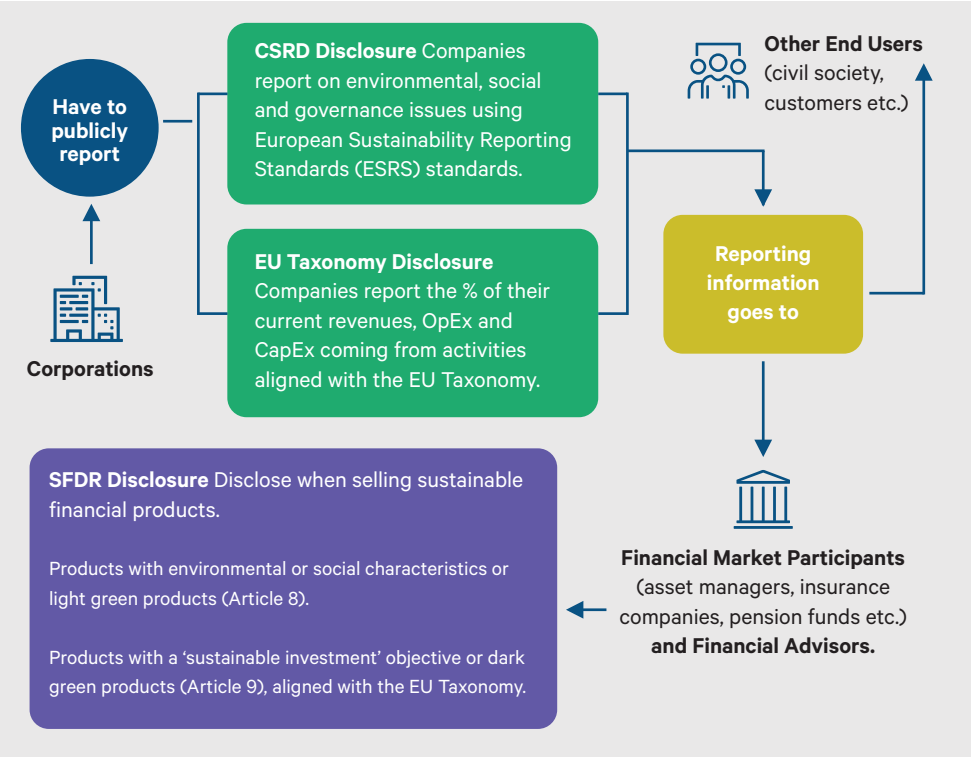
Regulation is driving demand from investors and other stakeholders for enhanced transparency on ESG matters from corporates.

Major advances have been made in the EU and internationally in the development of standardised and mandatory ESG disclosure frameworks, many of which are making their way into mainstream disclosure statements alongside financial information.

ESG disclosure proposals that will impact corporates in Ireland include the outcomes from the **EU Sustainable Finance Action Plan** and the IFRS Foundation's creation of the **International Sustainability Standards Board** (ISSB).

The EU Sustainable Finance Action Plan is driving a sustainable capital markets transformation. It aims to reorient capital flows towards sustainable investment, mainstream sustainability in risk management and foster transparency and long-termism in financial and economic activity. The EU Taxonomy creates a classification of sustainable economic market activities. The Sustainable Finance Disclosure Regulation (SFDR) launched in March 2021 is driving financial market participants towards making sustainable investments and disclosing progress. The Corporate Sustainability Reporting Directive (CSRD) is mandating corporations to disclose their sustainability performance and progress across ESG toward best practice. The figure below illustrates the push and pull market forces the Sustainable Finance Action Plan framework is using and disclosure requirements. Recent changes to MIFID II sustainability preferences for investors will further drive capital towards sustainable investments.

Figure 1 : EU Sustainable Finance Framework[adapted 1]



Source: EU Commission

1 Factsheet: How does the eu taxonomy fit within the sustainable finance framework? (europa.eu)

CSRD

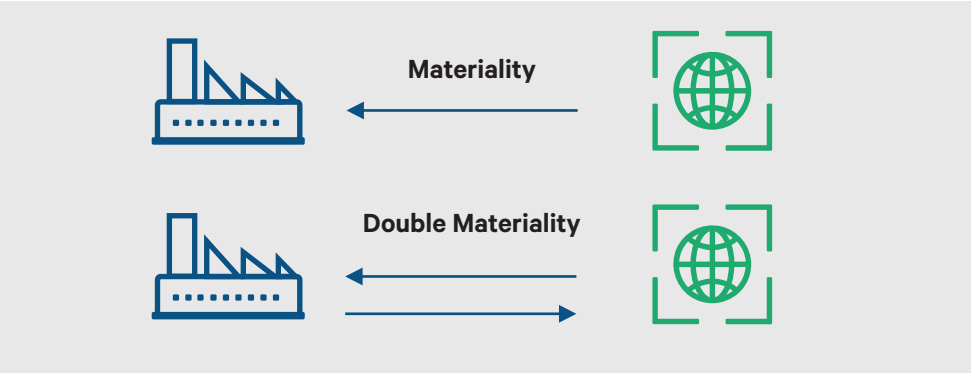
The now approved **CSRD** (which replaces the current **Non-Financial Reporting Directive - NFRD**) and its reporting requirements as outlined by the **European Sustainability Reporting Standards** (ESRS), developed by the **European Financial Reporting Advisory Group** (EFRAG) will apply to fiscal years starting on or after 1 January 2024 with reporting starting from 2025. Some key components of the CSRD and ESRS include:

- The concept of "**due diligence**" requiring undertakings to carry out to identify, assess, prevent, mitigate and remediate the actual and potential adverse impacts connected with its operations, products or services through its own activities and its business relationships.
- **EFRAG standards.** In November 2022 EFRAG approved twelve ESRS standards. These standards outline reporting requirements for a range of ESG issues covering cross-cutting, environmental, social and governance.
- Disclosure of sustainability information from upstream and downstream in the value chain will lead to changes in procurement, potentially favouring those with available sustainability information.
- In **scope companies** are EU companies (including EU subsidiaries of non-EU parent companies) who exceed at least two of the following criteria:
  - 250+ employees
  - Total balance of €20m+
  - Revenue of €40m+

- **Mandatory verification and assurance**: the Commission has proposed that 'limited' assurance should be given to CSRD disclosures, audited by independent assurance service providers. This will transition to a requirement for "reasonable" assurance (a stronger, more demanding level) in due course. "Reasonable" assurance will require the use of sustainability assurance standards – current best practice includes ISO14064, 65 and ISAE 3000.[2]

- The concept of "**double materiality**": requires disclosure on both how sustainability issues affect a company's financial performance, as well as the impacts of the company's activities on the environment and people.

Figure 2: Double materiality[3]



Source: LSE

2 ISO 14064-1:2018 Greenhouse gases — Parts 1-3: Specification with guidance at the organization level for quantification and reporting of greenhouse gas emissions and removals. ISO 14065:2013 - Requirements for greenhouse gas validation and verification bodies for use in accreditation or other forms of recognition. ISAE 3000 is the standard for assurance over non-historical financial information.

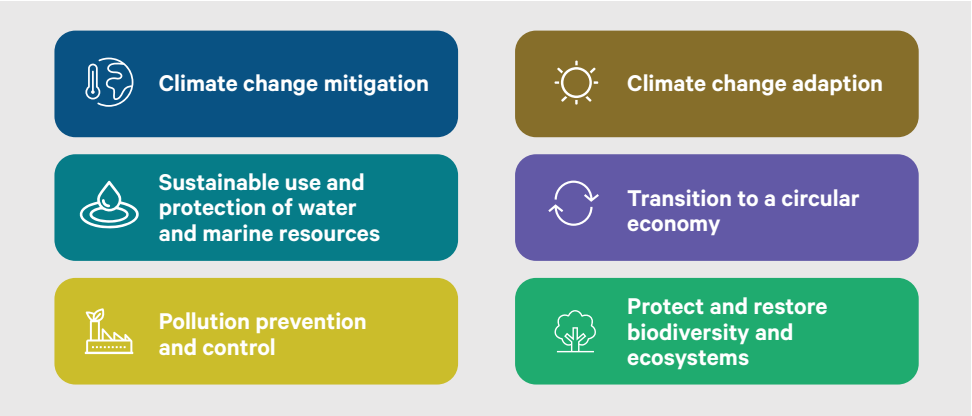
3 Figure 2: Double materiality www.lse.ac.uk/granthaminstitute/news/double-materiality-what-is-it-and-why-does-it-matter/

EU Taxonomy

In addition to CSRD reporting, companies who are currently in scope for the NFRD will need to report the percentage of their activities aligned with the **EU Taxonomy**. The EU Taxonomy is a science-based classification system which provides a standard for determining whether an economic activity can be considered environmentally sustainable.

The framework provided by the EU Taxonomy regulation will assess companies and funds against a number of criteria focused on six key environmental objectives, as outlined in the figure below.

Figure 3: EU taxonomy six environmental objectives[4]



Source: EU Commission

For an activity to be considered "sustainable" it must:

- contribute to at least one of the six objectives,
- "do no significant harm" to the remaining six objectives,
- meet "minimum safeguards" such as the UN Guiding Principles on Business and Human Rights[5] to not have a negative social impact and
- comply with the technical screening criteria developed by the EU Technical Expert Group (TEG)[6].

Currently, technical screening criteria is only available for two of the six environmental objectives; climate change mitigation and adaptation. The remaining four technical screening criteria are scheduled to be published by the TEG before the end of the year.

To comply with the EU Taxonomy, corporates must now report the percentage of their turnover, CapEx and OpEx that is considered "Taxonomy-eligible". Starting from 2023, companies will be required to use the Technical Screening Criteria to assess if their activities are "Taxonomy-aligned".

Information disclosed by corporates through the CSRD and EU Taxonomy is used as input to disclosures by investors under the requirements of the SFDR legislation.

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4 EU Commission - https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en

5 The UN Guiding Principles on Business and Human Rights are a set of guidelines for States and companies to prevent, address and remedy human rights abuses committed in business operations https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf

6 The European Commission (EC) setup a Technical Expert Group on Sustainable Finance (TEG) in June 2018 to support the implementation of measures identified in its 2018 Action Plan on Financing Sustainable Growth. https://www.greenfinanceplatform.org/policies-and-regulations/technical-expert-group-sustainable-finance-set-up-help-implement-measures

SFDR

The **SFDR** imposes mandatory ESG disclosure obligations for asset managers and other financial markets participants. Different investment strategies may entail investments in economic activities with different levels of environmental performance. For this reason, the SFDR distinguishes requirements for financial products that claim to promote social or environmental characteristics (often called Article 8 or light green financial products) and financial products that claim to have "sustainable investment" as their objective (often called Article 9 or dark green financial products).

Table 1: What are net zero emissions?

Article 6 - All Funds	Article 8 - All ESG	Article 9 - Sustainable
■ All managed products	■ 'Light green' funds	■ 'Dark green' funds
■ No integration of sustainability	■ Promotes, among other characteristics, environmental or social characteristics, or a combination but is not a main focus	■ Investment in economic activity that contributes to environmental objective
■ Can include stocks that are excluded from ESG funds, such as tobacco and coal producers, and should be clearly labelled as non-sustainable		■ Fund manager may be required to track an EU climate transition benchmark
		■ "Do no significant harm"

Source: Davy Horizons

Increasing level of disclosure →

Whilst Article 8 funds can choose whether to be Taxonomy aligned in whole, in part or not at all, Article 9 funds will have to align to a least one of the Taxonomy criteria and do no significant harm to the others. The latter are linked to the EU Taxonomy in that its environmentally sustainable activities are "sustainable investments" suitable for dark green financial products.

Potentially the most challenging aspect of the SFDR is the Principal Adverse Impacts (or PAI) regime. Principle Adverse Impact indicators are a set of mandatory indicators and metrics which aim to show financial market participants how certain investments pose sustainability risks. Under these rules, fund managers, financial advisors and other financial institutions will need to collect ESG data and disclose, on a comply or explain basis, any sustainability risks associated with their investments and financial products.

As illustrated in Figure 4, 14 key indicators (9 indicators related to the environment, and 5 social factors) are considered mandatory for the proper assessment of adverse sustainability impacts across a range of ESG factors.

Figure 4: Mandatory adverse sustainability indicators

Climate and other environment indicators	Social and governence indicators
■ GHG emissions (Scope 1, 2, 3 & total) ■ Carbon footprint ■ GHG intesity ■ Fossil fuel sector ■ Non-renewable energy consumption and production ■ Energy consumption intensity per high impact climate sector ■ Biodiverstity sensitive areas ■ Emissions to water ■ Hazardous waste ratio	■ Violations of UN Global Compact principles and OECD Guidlines ■ Lack of processes and compliance mechanisims to monitor compliance with UN Global Compact principles and OECD Guidlines ■ Gender pay gap ■ Board gender diversity ■ Exposure to controversial weapons

Source: Davy Horizons

The PAI statement which should be disclosed on the investors website and within product documents is intended to show investors and prospective investors how investment decisions made by a financial market participant are (or are not) impacting a prescribed set of mandatory sustainability indicators, and several voluntary ones.

The enhanced quality and availability of investee company information disclosed through the CSRD, will create a coherent and consistent flow of sustainability information that can be used by investors to meet their reporting requirements under the SFDR.

For more detail on the impact of the SFDR on corporates, read SFDR: ESG 2.0 for PLCs from Davy Horizons.

Convergence on global reporting standards

Launched at COP26 in 2021, the **International Sustainability Standards Board (ISSB)** run by the International **Financial Reporting Standards Foundation (IFRS)**, aims to create a comprehensive global baseline for sustainability disclosures.

The ISSB are developing Sustainability and Climate risk Disclosure Standards, that address companies' impacts on sustainability relevant to assessing enterprise value and making investment decisions. Two proposed drafts have been published to date;

- IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information: which will require companies to disclose information that enables investors to assess the effect of significant sustainability-related risks and opportunities.

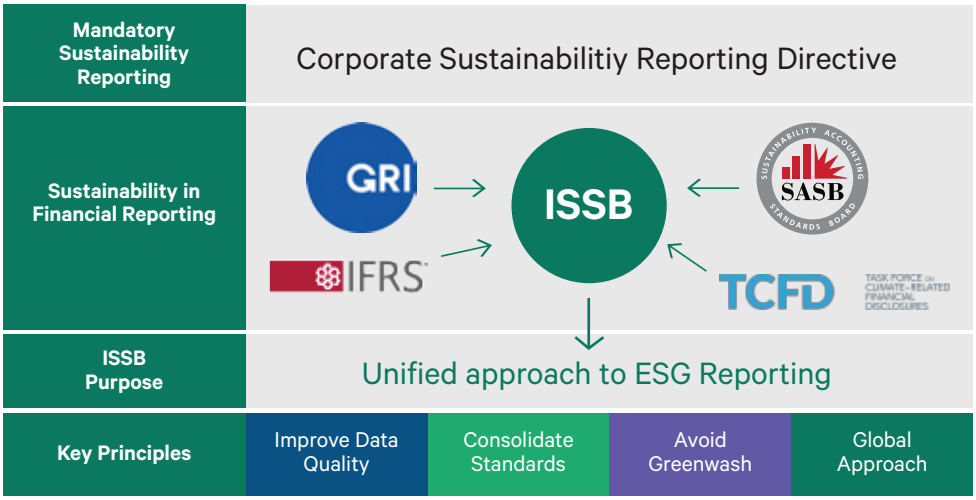
- IFRS S2 Climate-related Disclosures: which are more specific standards aimed at identifying, measuring and disclosing a company's material climate-related risks and opportunities. This standard will incorporate the TCFD requirements.

The ISSB's standards will enable companies to provide comprehensive sustainability information for the global financial markets. The standards will be developed to facilitate compatibility with requirements that are jurisdiction specific or aimed at a wider group of stakeholders (for example, the EU's planned Corporate Sustainability Reporting Directive as well as initiatives in the Americas and Asia-Oceania).

The G20 Finance Ministers and Central Bank Governors, Securities and Exchange Commission (SEC) and the Financial Stability Board are engaged in the IFRS Foundation's work.

The ISSB intends to align with the Task Force on Climate-related Financial Disclosures (TCFD), Global Reporting Initiative (GRI) and has incorporated Sustainability Accounting Standards Board (SASB) Materiality Standards per sector. CDP has also confirmed it will align with the ISSB regarding its annual disclosure questionnaires.

Figure 5: Sustainability in financial reporting



Source: Davy Horizons

The disclosure expectation is that ISSB related reporting will be part of a company's mainstream financial report – highlighting the equal importance the IFRS Foundation has placed on sustainability reporting alongside financial reporting.

The two standards have been through consultation and the ISSB are in the process of updating them. With regards to GHG emissions, the ISSB has recently confirmed[7] that Scope 3 GHG emissions disclosure will now also be a requirement under its framework, a decision welcomed by asset managers globally. The final publication for the two proposed ISSB standards is due in early 2023. The ISSB has also stated its intention to release additional thematic standards in the future.

Efforts are being made by the ISSB and EFRAG to ensure that there is alignment between their two ESG reporting frameworks. However, there are still a number of differences in the ISSB and EFRAG's approach that corporates should be aware of when preparing for reporting, these are outlined in the table below:

Table 2: ISSB vs EFRAG

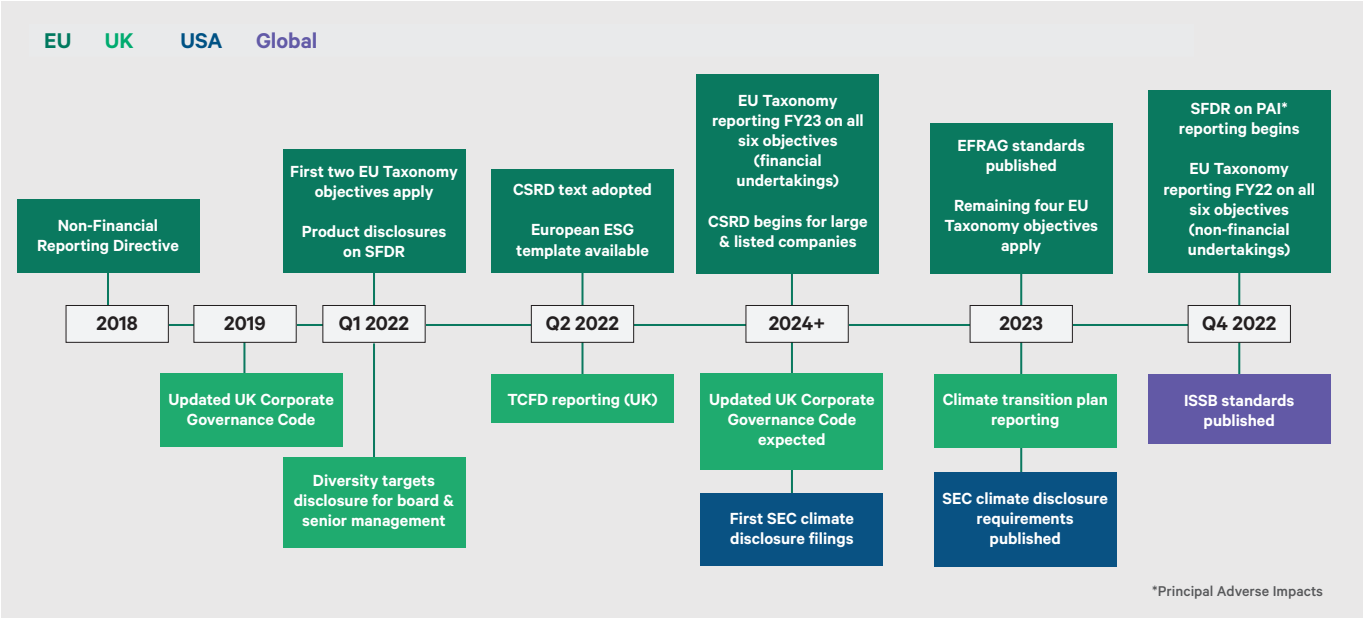
	ISSB	EFRAG
Stakeholder focus	Investors	Multi-stakeholder
Scope of reporting requirements	Determined by individual jurisdictions	Broad range of listed & private EU companies or groups & non-EU companies with significant operations in the EU.
Information required to be disclosed in annual report?	Yes	Yes
Disclosure at the same time as financial statements?	Yes	Yes
Inclusion of industry-specific disclosures	Climate industry-specific disclosures with SASB standards considered for other topics.	Industry-specific standards to be launched in 2023.
Assurance requirements	No mandate to require assurance but information to be verifiable.	Limited assurance initially moving to reasonable assurance no later than Q4 2026.
Materiality	Single – information material to investors.	Double – how sustainability impacts financial performance + environment & people.

Source: Davy Horizons

7 IFRS, October 2022, ISSB unanimously confirms Scope 3 GHG emissions disclosure requirements with strong application support, among key decisions https://www.ifrs.org/news-and-events/news/2022/10/issb-unanimously-confirms-scope-3-ghg-emissions-disclosure-requirements-with-strong-application-support-among-key-decisions/

As well as the standards being published by the ISSB and EFRAG, other jurisdictions are also progressing ESG reporting requirements. For companies domiciled in the UK, recent announcements around the requirement for the disclosure of transition plans have reiterated the likelihood of the UK using the ISSB standards as a core component of the UK's sustainability disclosure requirements alongside their existing TCFD-aligned disclosure rules[8]. In addition, the UK's Corporate Governance Code is expecting an update in 2024, which will focus on auditing and assurance of ESG information. In the USA, the Securities and Exchange Commission (SEC) issued a proposal in March 2022 that would significantly enhance climate-related disclosures in annual filings and registration statements. Similar to the ISSB, EFRAG and the UK, the SEC proposal also uses the TCFD framework as a basis for its disclosure requirements.

Figure 6: Reporting requirements timeline



Source: Davy Horizons

8 Transition Taskforce, November 2022, UK Transition Plan Taskforce launches new gold standard for best practice climate transition plans. https://transitiontaskforce.net/uk-transition-plan-taskforce-launches-new-gold-standard-for-best-practice-climate-transition-plans-by-privatehttps:/transitiontaskforce.net/uk-transition-plan-taskforce-launches-new-gold-standard-for-best-practice-climate-transition-plans-by-private-sector-firms/-sector-firms/

Evolution of tools to support reporting

One of the key requirements coming from the EU Taxonomy, SFRD, CSRD, the standards being developed by EFRAG and the ISSB, is structured electronic tagging of a company's sustainability disclosures. While little detail is currently known on what this will look like in practice it highlights digitalisation and structured specific information as a key part of implementing ESG reporting requirements. Companies will be required to prepare both their financial statements and their mangement report in a single digital format and mark up sustainability information, tagged in accordance with a digital taxonomy.

Some additional tools and templates that can support corporates on the ESG disclosures include:

- The **EU Taxonomy compass tool**[9] which aims to make the contents of the EU Taxonomy easier to access for a variety of users. It enables users to check which activities are included in the EU Taxonomy (taxonomy-eligible activities), to which objectives they substantially contribute and what criteria they have to meet.

- When reporting to the EU Taxonomy, companies can reference the table developed by the **Platform on Sustainable Finance** using the reporting requirements in Annex II of the Delegated Act[10], see Table 3 below. While use of the table is voluntary for EU Taxonomy disclosures, it provides a comprehensive method for reporting the turnover, CapEx and OpEx associated with Taxonomy eligible or aligned activities.

- The **European ESG Template (EET)** developed by FinDatEx[11]. While the intended use of this template is for financial institutions developing their SFDR disclosures, the tool is useful to corporates as it allows them to understand the format that investors will use and request their information in.

9 EU Taxonomy Compass Tool https://ec.europa.eu/sustainable-finance-taxonomy/tool/index_en.htm

10 EUR-Lex - 32021R2139 - EN - EUR-Lex (europa.eu) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX-%3A32021R2139

11 EET Template https://findatex.eu/

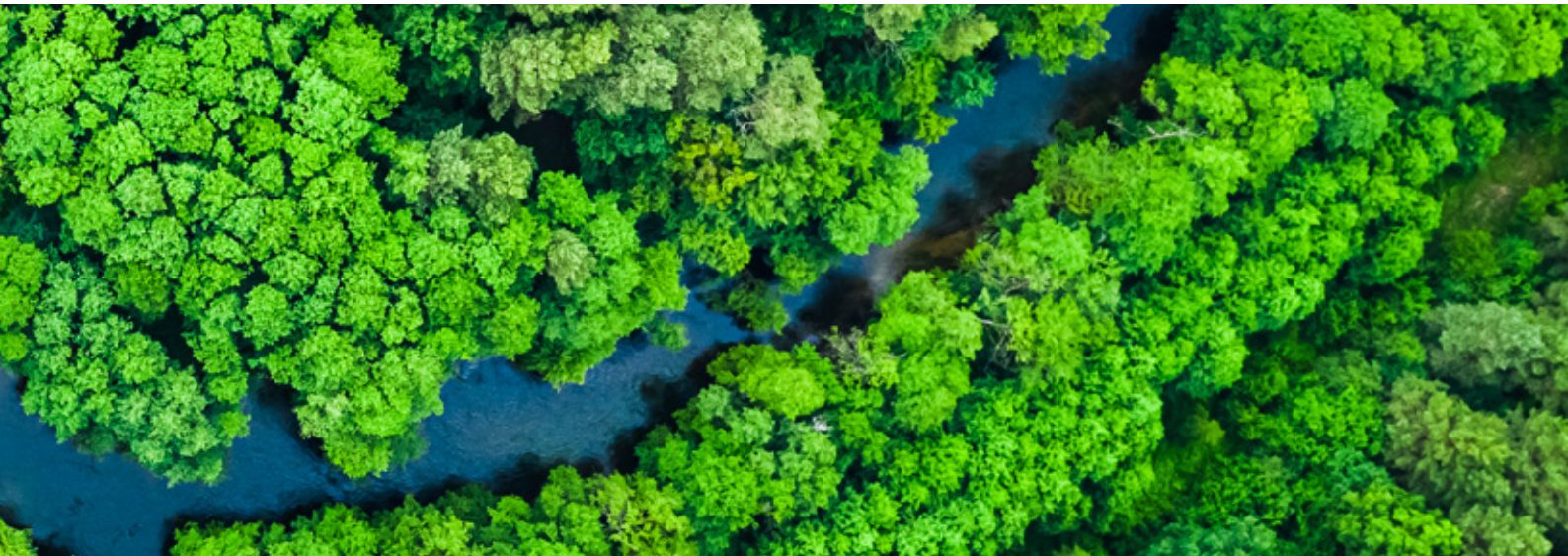


Table 3: Example EU taxonomy reporting table[12]

All data consistent with FYE reporting				Substantial Contribution Criteria										DNSH criteria ('Does Not Significantly Harm')											
Economic Activities (1)	Code (2)	Absolute turnover (3)	Proportion of Turnover (4)	Climate Change Mitigation (5)	Climate Change Adaptation (6)	Water (7)	Pollution (8)	Circular Economy (9)	Biodiversity and ecosystems (10)	Climate Change Mitigation (11)	Climate Change Adaptation (12)	Water (13)	Pollution (14)	Circular Economy (15)	Biodiversity (16)	Minimum Safeguards (17)	Taxonomy aligned proportion of turnover, year N (18)	Taxonomy aligned proportion of turnover, year N-1 (19)	Category (enabling activity) (20)	Category (transitional activity) (21)
Text		Millions, local CCY	%	%	%	%	%	%	%	Y/N	Y/N	Y/N	Y/N	Y/N	Y/N	Y/N	%	%	E	T
A. TAXONOMY-ELIGIBLE ACTIVITIES (A.1. + A.2.)			82%	20%	11%															
A.1. Environmentally sustainable activities (Taxonomy-aligned)																				
Activity A		20.00000	20%	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Activity B		11.00000	11%	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	E	-
Turnover of environmentally sustainable activities (Taxonomy-		31.00000	31%	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-		
A.2 Taxonomy-Eligible but not environmentally sustainable activities (not Taxonomy-aligned activities)																				
Activity C		20.00000	20%																	
Activity D		18.00000	18%																	
Activity E		5.00000	5%																	
Activity F		8.00000	8%																	
Turnover of Taxonomy-eligible but not environmentally sustainable activities (not Taxonomy-aligned activities) (A.2)		51.00000	51%														-	-		
B. TAXONOMY-NON-ELIGIBLE ACTIVITIES																				
Turnover of Taxonomy-non-eligible activities		18.00000	18%																	
Total (A+B)		100.00000	100%																	

12 Source: EN - EUR-Lex (europa.eu) https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-eligibility-reporting-voluntary-information_en.pdf

Top tips for future proofing your business for financial reporting for sustainability

Outlined below are next steps for ensuring that your business is ready for upcoming sustainability reporting requirements.

- **Step 1: Conduct a baseline assessment.** Corporates should assess their existing sustainability and ESG reporting procedures to understand their baseline, including which Key Performance Indicators (KPIs) they currently track. They should benchmark their current reporting practices with peers and best practice frameworks, and assess sustainability risks with regard to the double materiality concept outlined in the CSRD.

- **Step 2: Get ready for assurance.** Corporates should conduct a regulation horizon scan and identify any reporting obligations they are required to comply with and when they come into force. Information disclosed under the ISSB standard needs to be verifiable while information under CSRD needs to be assured.

- **Step 3: Create a roadmap.** Corporates should create a roadmap with inputs from key stakeholders from around their business to ensure that they are ready for all upcoming material reporting obligations. This may include determining EU Taxonomy eligibility and alignment, reshaping current management report structures to accommodate increases in non-financial information and preparing for assurance, among other key actions.

- **Step 4: Improve data management systems.** Corporates should engage their internal teams to get an understanding of existing data management processes and identify any gaps. They should ensure that they have the right people in place and train them to be prepared to report the data and consider implementing digital solutions for more efficient data management and controls.

- **Step 5: Get good at TCFD reporting.** The TCFD framework is a foundational part of essentially every new emerging ESG reporting framework. Corporates should look to either begin reporting against the requirements of the TCFD or begin to develop their assessments of their climate-related risks and opportunities by improving scenario analysis and ensuring that climate-related risk assessment is embedded in their company's business systems.

How Davy Horizons can help

DAVY

Davy Horizons is the sustainability and ESG consultancy in Davy Group. We support organisations develop, implement and report on best practice regarding climate change and wider sustainability issues across all ESG verticals to support a long-term future. We also run thought leadership events and publish insights to ensure organisations have the latest intelligence. For further information visit **Davy Horizons**.

Are you ready to take the next step?

Talk to us today.
Email **sustainability@davy.ie** or visit **davy.ie/horizons**

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