EXPERT | ESG IN FINANCIAL REPORTING

TRANSFORMING TRANSPARENCY

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Understanding environmental, social, and governance (ESG) issues within a company's business model can be challenging, and incorporating business partners into this analysis makes the task even more daunting. Yet, in light of the EU sustainability reporting regulations, companies should do that. The introduction of the European Financial Reporting Standards (ESRS) has brought about a requirement to perform analysis of the so-called double materiality. Companies covered by the Corporate Sustainability Reporting Directive (CSRD) must identify significant negative and positive impacts of their business operations on the environment, including ESG risks and opportunities resulting from the environment's impact on the enterprise.

That involves the analysis of the entire value chain, including the company's contractors and customers.

CHALLENGES

The ESRS standards specify diverse ESG areas that companies must identify as having significant impacts upon, including risks and opportunities, through double materiality analysis. Different industries may have their unique impacts and risks. For example, the environmental footprint of a manufacturing company significantly differs from that of a service provider.

Sectoral standards can support the entity in analyzing significant impacts, risks, and opportunities in the value chain. The European Financial Reporting Advisory Group (EFRAG) is developing a set of sector-specific ESRS standards to indicate significant topics within industries to be reported by companies operating within those sectors.

Navigating these requirements and ensuring compliance with ESRS standards requires a deep understanding of the industry and its key ESG issues. Preparing an initial outline of the enterprise's value chain is essential for the correct identification of significant topics subject to double materiality analysis. Such identification and prioritization of impacts, risks, and opportunities can be a complex and time-consuming process.

COMPLEXITY

When analyzing the value chain, it is critical to note that impacts, risks, and opportunities may encompass the enterprise's operations and its higher and lower-tier value chains—the so-called upstream and downstream—including customers and suppliers.

The number of suppliers and other stakeholders from whom the enterprise buys products and services, along with the levels of the value chain where significant interactions may occur, complicate the determination of essential sustainability topics.

Initial classification of suppliers and subsequent collection of comprehensive and accurate data about stakeholders at various levels of the value chain facilitate this process. Unfortunately, data fragmentation in different corporate accounting systems hinders obtaining a holistic view of contractors and purchased products.

Integrating various data sources into a coherent framework compliant with ESRS standards can be challenging for enterprises, as it requires robust data management systems capable of handling different data sources, formats, and quality levels.

ENGAGEMENT AND COMMUNICATION

Effective engagement and communication with multiple stakeholders in the value chain is another challenging step, requiring strategic approaches and the ability to balance conflicting interests. Communication strategies should rely on a dialogue tailored to specific types and stakeholder groups to ensure the highest effectiveness in reaching information while considering the enterprises' available human and time resources.

Most companies currently base their activities on codes of conduct for suppliers, which, although practical for identifying and managing suppliers, are often insufficient for fully identifying impacts, risks, and opportunities in the supply chain because of the lack of information about the actual actions of suppliers and the dynamic nature of ESG risks, which can change due to shifts in contractors' business profiles and new regulations.

NEXT STEPS

Assessing the impacts, risks, and opportunities does not end with stakeholder engagement and communication. ESG risk and opportunity analysis requires an approach that considers detailed information about locations, facilities, and other specific details related to suppliers and customers at various levels of the value chain, as indicated in the OECD Guidelines for Responsible Business Conduct.

Data obtained from contractors can be effectively used in scenario analysis, in which the enterprise assesses the impact of risks and opportunities in different time horizons and social and climate change configurations. It is particularly significant when assessing risks that can affect the prices of acquired goods and services related to climate change—the physical, such as sudden weather changes that can significantly impact delivery timeline and transitional risks related to regulatory and market dynamics. Scenario analyses help capture the evolving nature of impacts, risks, and opportunities, enable more effective monitoring of these changes and allow organizations to adapt their strategies to current and anticipated realities.

CONCLUSIONS

At present, the majority of companies subject to the CSRD directive and ESRS standards are just beginning to identify and analyze impacts, risks, and opportunities within their value chains through the double materiality assessment. The regulator has provided exemptions in the first three years of sustainability reporting, during which companies subject to the CSRD directive do not have to disclose all information about their value chains if such information is not readily available. However, this exemption does not cover the information scope outlined in Annexes B and C of the ESRS 2 Standard. Thus, the transition period should be used by enterprises to best prepare for gathering and reporting information about impacts, risks, and opportunities related to their value chains after the transition period. Arguably, this will be one of the most enduring challenges enterprises have faced in sustainability reporting in recent times.