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Comment letter to the public consultation on the EFRAG's Exposure Draft European Sustainability Reporting Standards for listed SMEs (ED ESRS LSME)

Dear Ms. Del Prete and Mr. de Cambourg,

we are pleased to have the opportunity to respond to the public consultation on the Exposure Draft European Sustainability Reporting Standards for listed small and medium-sized enterprises (LSMEs) (ED ESRS LSME).

We welcome EFRAG's efforts to simplify the reporting requirements for small and medium-sized enterprises (SMEs). Nevertheless, in our view, the current exposure draft establishes a set of rules, which might be infeasible for some (L)SMEs. For example, the materiality assessment of financial risks is supposed to be based on long-term scenario analyses (Section 1, AR 17), which are not necessarily covered by implemented risk management systems. As further example, the impact materiality assessment needs to consider water consumption in areas at water risk along the entire upstream and downstream value chain (Section 3, AR 20). In order to be able to perform such analyses through the entire value chain in a substantiated manner, not only specialized skills but also a considerable number of employees are required. As LSMEs are characterized by a low number of employees, i.e., less than 250 or even less than 50 employees, and should mostly not fall within the scope of CSDDD, we fear that the requirements proposed by EFRAG are excessive for LSMEs and can only be fulfilled at what we consider extremely disproportionately high cost.

That is why we strongly advocate substantial reductions of complexity for (L)SMEs throughout the exposure draft. In the following, our comment letter summarizes selected issues in the ED ESRS LSME from a preparer's point of view.

1. Harmonization of size- and sector-specific standards (ESRS, ESRS LSME, ESRS VSME and ESRS SEC)

We understand that specific standards for companies of different sizes and belonging to different sectors should take into account the respective needs and characteristics of the reporting companies. Particularly in view of the scope and complexity of the planned sustainability reporting, we believe it would be expedient to implement meaningful simplifications - also for the addressee - by developing uniform ESRSs for all SMEs, irrespective of a market listing. Such uniform ESRS for SMEs could be completely voluntary for non-listed companies, which is from our point of view in fact provided for by the CSRD (see CSRD, recital 21). For LSMEs, in turn, only a subset could be made mandatory and an optional reporting could be permitted for other components, e.g. in the same way as the Exposure Draft Voluntary standard for non-listed SMEs (ED ESRS VSME) is structured.

This would not only foster uniform reporting, but also create applicable standards for voluntary consolidated sustainability reporting of LSMEs, which are currently not considered (see ED ESRS LSME, Section 1, paragraphs 1 and 6 versus ED ESRS VSME paragraph 12 and ESRS 2 paragraph 5). In order to enhance the access of LSMEs to financial capital and to ensure that financial market participants have the information they need (see CSRD, recital 21), it may be appropriate for LSMEs to report the sustainability information on a consolidated basis. This may be particularly useful if the LSME only reports a combined consolidated management report together with the consolidated financial statement, whereby the combined consolidated management report then has to include its individual sustainability statement with disclosure requirements (DRs) of references and reconciliations to the consolidated financial statement (see ED ESRS LSME, Section 1, paragraphs 115 and 116).

While sector-specific regulations are understandable for non-SMEs, a more extensive distinction of reporting requirements for SMEs, especially to those operating in in several highly differentiated sectors or with very complex value chains, would impede the objective of reducing complexity. Therefore, it should be clarified, that sector-specific regulations are applicable to SMEs only to an extent that does not exceed the requirements of ED ESRS LSME.

2. Double materiality assessment

2.1. Value chain considerations in the impact materiality assessment

A main source of application complexity stems from the requirement to include sustainability matters arising in the value chain including business relationships, which are explicitly neither limited to direct contractual relationships (ED ESRS LSME, Section 1, paragraph 45) nor limited to the scope of financial control (ED ESRS LSME, Section 1, paragraph 52). As the scale, scope and irremediable character of an impact occur independently of the specifics of a business relationship in the value chain, regardless its extent and nature, in accordance with ED ESRS LSME this business relationship needs to be taken into account when performing the impact materiality assessment.

Even though the standard does provide for undertakings to be able to fall back on substitute information (such as sector averages and proxies) in the event of missing information, the capacity required to carry out and particularly document such a materiality assessment for the direct and indirect business relationships along the entire value chain is enormous. Besides this, the influence of (L)SMEs on value chain actors and on business relationships is due to its nature limited. The same applies regularly to their (direct) contribution to the impacts on sustainability matters arising in the value chain.

Taking into account (L)SMEs' limited capacities and influence on actors in their value chain, particularly in comparison to large undertakings, meaningful simplifications for LSMEs necessarily comprise substantial reductions in the complexity of the materiality assessment. In order not to burden LSMEs with the same requirements as for large undertakings in the context of the materiality assessment, we suggest to increase the focus on the LSME's own business activities and thus to restrict the assessment of impact materiality to the key direct business relationships of LSMEs and to the key components of their products and services. This could be achieved by limiting the impact materiality assessment of the value chain and business relationships to those fulfilling the following requirements:

- A) the value chain, the value chain actor or the direct business relationship is considered to be among the most significant from the undertaking's perspective, **and**
- B) the business relationship with the undertaking is among the most significant from the counterparty's perspective.

The first requirement (A) would take up the principle of "key business relationships" applied within Section 2 - General Disclosures ("key business relationships [...] and their key characteristics, its key activities, key suppliers, key resources, key distribution channels, and key customer segments", see Section 2, AR 9). In our view, materiality assessment and the resulting reporting should be based on consistent principles.

The second requirement (B) takes into account the (direct) influence of the LSME on an (negative) impact in the value chain.

2.2. Shareholdings in the impact materiality assessment

Business relationships as defined by ESRS Annex II do also include any shareholding positions in joint ventures or investments.

ED ESRS LSME Section 1 paragraph 62 deems to make a distinction between subsidiaries, associates or joint ventures that are part of the undertakings value chain and those that are outside the undertakings value chain (similar to ESRS 1 paragraph 67). It might be concluded from this differentiation that different reporting requirements are envisaged for shareholdings, which are part of the value chain and for those outside the value chain of an investor.

On the other hand, other (draft) statements suggest that shareholdings in general constitute business relationships without any further differentiation (e.g., Draft EFRAG VCIG, paragraphs 49 and 75-77).

It therefore remains unclear whether equity investments that are not accounted for as subsidiaries (no operational or financial control) constitute business relationships that are – by definition – part of the value chain and thus trigger potentially reportable information or whether there are investees that are deemed to be outside the undertaking's value chain. If the latter holds true, it should be clarified how investees outside the value chain are defined, whether and how they have to be taken into account in the materiality assessment and which reporting requirements apply to business relationships, which are solely based on the equity investment, with such investees – in particular for LSMEs.

ESRS and the current ED ESRS LSME do only provide guidance on the treatment of operational business relationships (actors in the value chain) but not on other business relationships (see Draft EFRAG VCIG, paragraph 49 for joint ventures and associates, and paragraph 50 for investments without joint control and/or significant influence).

This is acknowledged in the Draft EFRAG VCIG (which does not apply to LSMEs according to the disclaimer of Draft EFRAG VCIG) with reference to the forthcoming sector specific ESRS (see Draft EFRAG VCIG paragraphs 78 and 124). However, it is already understandably stated that holding companies that are not considered financial institutions are out of the scope of the sector specific ESRS for the sector group financial institutions (see EFRAG Working Paper ESRS SEC 1 Sector Classification, 15 January 2024, paragraph 11).

Thus, the business model of such a holding company is not addressed by current ESRS regulation. Consequently, it is particularly unclear, how the impacts of investees in their own operations and alongside their value chain have to be considered in the (gross) impact assessment of the holding company (see Draft EFRAG VCIG, paragraph 38).

If investees of holding companies are treated analogously to actors in the value chain of operating companies (customer-supplier-relationships), e.g. an investment of 405 % of the

shares and in the amount of €10 billion and an investment of only one share in the amount of €100 might have to be considered to an equal extent in the (gross) impact materiality assessment including the whole value chain of each investee. However, this might not lead to meaningful information.

We strongly advocate in favor of a conceptual differentiation between operational and merely financial business relationships in order to account for the different degrees of involvement of a holding company and limitations to availability of information.

We further propose that the impact materiality assessment should consider shareholdings based on the degree of influence in accordance with current accounting standards. Accordingly, LSMEs should not be obliged to include any shareholding positions in investees over which an undertaking does not even have a significant influence (in accordance with IAS 28) in their impact materiality assessment. This reflects the fact, that investors with minority shareholdings are regularly not in a position, where they "contribute" to a (negative) impact of an investee (also acknowledged by the OECD Guidelines).

It should be clarified in any case, that the impact materiality assessment on shareholdings outside the value chain is limited to the direct business relationship and does explicitly not require the undertaking to perform an impact materiality assessment on the investees entire upstream and downstream value chain.

2.3. Time horizons in the materiality assessment

The exposure draft requires undertakings to analyze the short, medium and long-term impacts of their business activities and alongside their value chain on people and the nature as part of the materiality assessment (Section 1, paragraph 74). In this context, reference is made to the internal management of risks in the sense of a management approach, which provides for deviations from the standardized time horizons (1 year, < 5 years, > 5 years), but does not allow the conclusion that the omission of medium and especially long-term time horizons is permissible.

In view of the predominantly long-term impacts of business activities on people and the nature as well as potential long-term risks against the backdrop of unpredictable natural and social changes, especially in case of crossed tipping points, this is more than understandable. However, the (risk) management systems currently set up by companies do not necessarily relate to such a differentiated and, above all, long-term assessment period. In particular, SMEs will hardly be able to carry out such assessments in an appropriate manner, or – at best – only at what we consider extremely disproportionately high cost.

With regard to the materiality assessment, we therefore suggest limiting the consideration of long-term impacts and risks to cases that are associated with the most significant impacts and

risks that are easily recognizable for management in the ordinary course of business without applying complex resilience and scenario analyses for every sub-sub-topic of the ESRS. In our view, such a simplification is particularly necessary to reduce documentation and disclosure requirements in relation to the assessment of long-term impacts and risks related to sustainability matters to an acceptable level.

Additionally, we would like to add, that from our point of view the derogated reporting requirements in art. 19a(6) and 29c, referring to art. 29b(2) to (5), of CSRD solely demand the disclosure of past and future oriented sustainability information but do not provide any specifications with regard to time horizons in terms of short-, mid-, and long-term and especially not in form of an obligatory time horizon of more than five years.

3. Disclosure requirements

3.1. Systematic simplifications of DRs for LSMEs

The disclosure requirements for LSMEs should be in line with the relevant recitals and articles of the CSRD for LSME. These call for clear simplification for LSMEs. The ESRS LSME should therefore be aligned with the derogated reporting requirements for LSMEs in CSRD art. 19a(6) and 29c, which refers to CSRD art. 29b(2) to (5). These merely recognize “that undertakings may encounter [difficulties] in gathering information from actors throughout their value chain” (art. 29b(4)) but do not require LSMEs to disclose information on the value chain. Information on the value chain is only required by large undertakings or groups in accordance to CSRD art. 19a(3) or 29b(3). The latter applies only to groups and their consolidated sustainability statement but not to individual sustainability statements.

To provide clear simplification for LSMEs, information on their value chain (including the datapoints on scope 3 emissions) should be voluntary. The ESRS LSME should therefore specify in general, that LSMEs “may” instead of “shall” report information on the value chain (to be specified e.g., in Section 1, paragraph 58).

At least, the limitation to “material value chain information” (Section 1, paragraphs 59 f.) ought to be interpreted as guiding principle for the scope of reporting for LSMEs. Consequently, the suggested simplification of the materiality assessment regarding the value chain (see no. 2.1. and 2.2.) should also result in reporting value chain information being limited to the key direct business relationships of LSMEs as well as to the key components of their products and services.

3.2. Derogating LSMEs' disclosure obligations by referencing

A clear simplification could also be the possibility to fulfill the entire reporting requirements related to sustainability matters arising from direct business relationships (in the value chain) by reference to sustainability statements of the respective actors. If the actor, to which reference is made, publishes an sustainability statement in accordance with CSRD on its own, we believe that sufficient information is already available for all interested stakeholders. This is especially valid considering the limited resources of SMEs. We therefore suggest to clarify that references to ESRS sustainability statements of actors in the value chain suffice entirely to fulfill the reporting requirements with respect to impacts and risks materiality assessment (Section 1, paragraph 66) as well as to policies, actions and targets (Section 1, paragraph 67).

3.3. Abolition of the temporal limitation of transitional provisions

The transitional provision related to chapter 4 "Value chain" (Section 1, paragraph 119) should be permanently applicable to LSMEs instead of only for the first three years of their reporting:

- LSME may permanently limit value chain information to publicly available information when disclosing information on policies, actions and targets.
- LSME shall permanently not be required to include upstream and downstream value chain information when disclosing metrics.

In line with this, the ESRS LSME should specify that the value chain information on GHG emissions (i.e., the datapoints on Scope 3 emissions) may be permanently omitted by LSMEs and not only for the first year of their reporting (analogous to phased-in DR to Section 4 E1-2 in Section 1, Appendix C). In regard to value chain information to be reported by LSMEs, the ESRS LSME should also provide to all LSMEs, or at least to those not exceeding the average number of 50 employees, that all disclosure requirements and application requirements related to workers in the value chain, affected communities and consumers and end-users may be omitted permanently instead of for the first two years of their reporting.

3.4. Intensity metrics based on the most relevant financial indicator

ESRS and ED ESRS LSME require metrics to be disclosed on an intensity base (e.g., Section 4 paragraph 21 DR "GHG Intensity based on net revenue"). However, for some undertakings, in dependency of their respective business model and sector, an intensity metric based on (net) revenue might not be the most relevant information to be provided to investors. This might be the case if the undertakings business model is not based on revenue within the meaning of international or local GAAP, e.g., as specified in Section 4, AR 3(e). Therefore, the ED ESRS LSME provide the option for credit institutions to replace net revenue with a different financial indicator (e.g. Section 4, paragraph 23).

However, it should be clarified in the ESRS LSME, that this option is

- i. provided throughout all disclosure requirements of ESRS LSME (e.g., currently not provided for Section 4, paragraph 9, DR "Energy intensity based on net revenue") and

- ii. not only applicable to credit institutions but to all undertakings with a most significant income stream other than revenue

This necessity can be illustrated by the example of Porsche Automobil Holding SE (Porsche SE) as a non-operating industry holding. Porsche SE does not report any revenues in its IFRS group financial statements. However, ED ESRs LSME does not apply to consolidated statements. Reference may therefore be required to Porsche SE's separate financial statements in accordance with local GAAP. For the fiscal year 2023 Porsche SE reports revenue of less than €0.1 million but an income from investments (dividends) of more than €1,500 million in its separate financial statements. As total GHG-emissions of Porsche SE include pro rata GHG-emissions of its investments from which dividends are received (scope 3) any intensity metric based on (net) revenue of Porsche SE would be completely misleading and not meet the qualitative characteristics of comparable, relevant and understandable information to be presented in sustainability statements.

4. Phased-in disclosure requirements provided by LSME ESRs should be aligned to phased-in disclosure requirements applicable to large undertakings or groups and also applicable if LSMEs opt out

The phased-in disclosure requirements provided by ED ESRs LSME partly deviate to the phased-in disclosure requirements provided by the full set of ESRs applicable to large undertakings and groups. Additionally, the phased-in disclosure requirements listed in Section 1, Appendix C are not applicable to LSMEs that opt out in accordance with Section 1, paragraph 121. In case an LSME decides to opt out for only one year, this might result in an earlier mandatory adoption of a disclosure requirement for the LSME than for large undertakings if an LSME decides to opt out for only one year.

We propose that the phased-in disclosure requirements provided by the ESRs LSME can also be applied by LSMEs opting out in order to align LSME regulation to the phased-in disclosure requirements provided by the full set of ESRs.

We value the opportunity to provide our comments on the consultation, and welcome further discussion on any of the points that we have raised.

Yours sincerely,

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