



# Sustainability

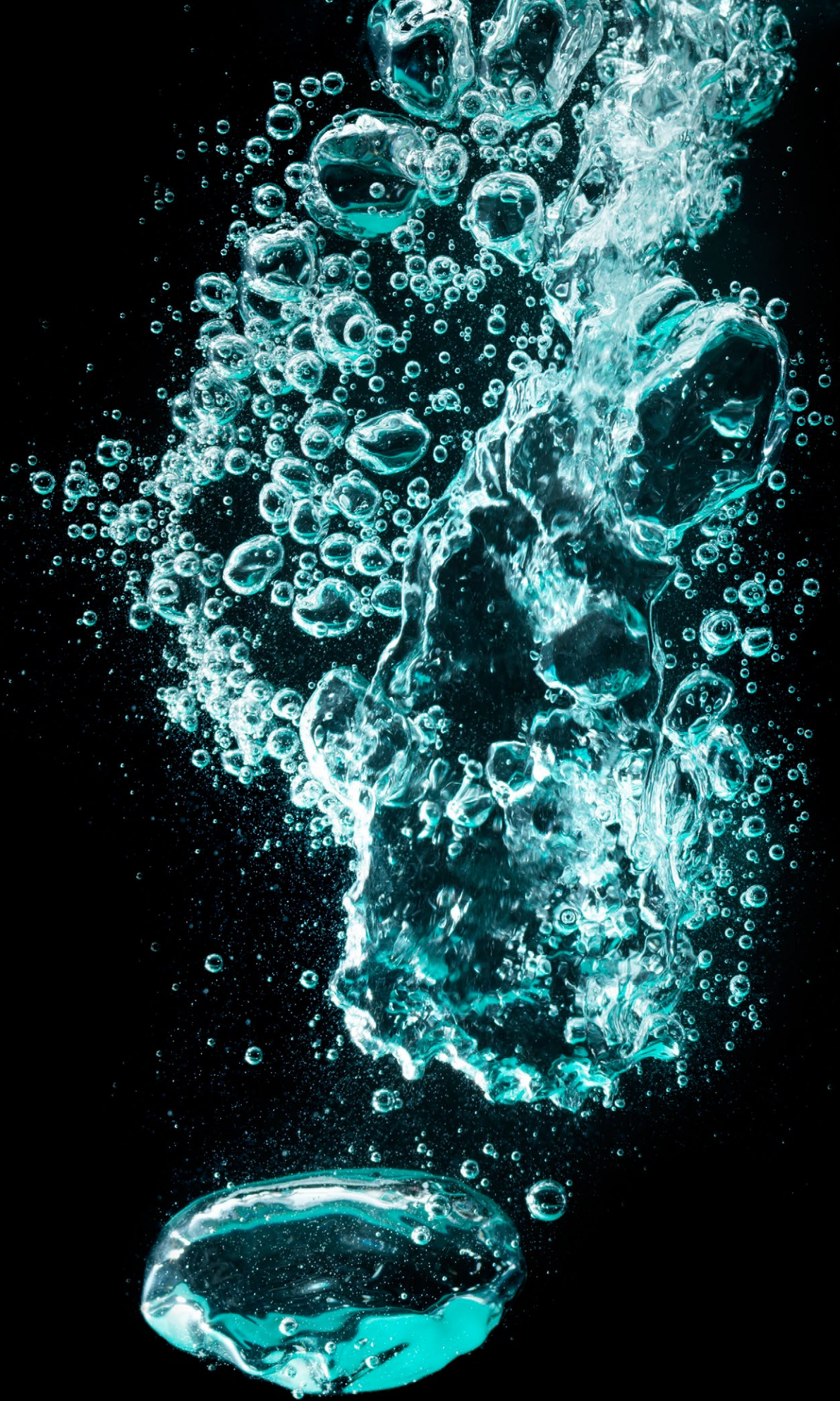
**A clear view on recent developments  
and why they belong on board agendas**

June 2021

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# ESG – a changing mindset

Climate protection is a fundamental right. According to a recent ruling by Germany's Federal Constitutional Court, this generation cannot be allowed to live at the expense of future generations. And by taking this stance, it is forcing both politicians and the business community to take even more decisive action. More than 100 states around the world have made a commitment to net zero emission targets or are considering doing so – and that is having corresponding repercussions on the economy. This is only one of the examples of a profound transformation that we are currently observing and with which boards of directors and top management are finding themselves confronted.

## Entire industries in a state of transition

How can we make it possible for more than 9 billion people to enjoy sustainably good living conditions without exceeding our planet's capacity to do so? That is the core question currently driving a transformation of businesses and entire industries. The comprehensive consideration and management of environmental, social and governance (ESG) factors supplements traditional management perspectives and is becoming a catch-all phrase that implies a holistic way to steer through this transformative business environment. Previously unreported, intangible assets as well as opportunity and risk profiles arising as a result of environmental and social trends have an impact on long-term financial performance. What does this transformation mean and how should a company's management approach the topic?

## Simply think about sustainability

Sustainability, ESG, CSR – a wide range of terms has emerged over time. It goes to follow that different stakeholder groups have interpretations and understandings of these terms that are just as diverse. It is becoming increasingly apparent that the general mindset is shifting away from a more isolated, moral-ethical view of corporate responsibility and toward one that comprehensively integrates environmental, social and governance (ESG) aspects into business strategies, decision-making processes and management approaches.

The success or purpose of a business can never be explained solely in terms of its financials, that much is clear. To be successful, a company must create social added value. A renunciation of the pure shareholder value concept in favor of a "shared value" or "stakeholder capitalism" perspective under which a company is only successful if its activities address urgent societal challenges while also benefiting financially from this approach. Given the challenges of climate change, for example, few companies would dispute that business models revolving around renewable energies have better long-term future prospects than those using fossil fuels. Many other examples can be found in the mobility sector, manufacturing industry, healthcare sector and even in the real estate sector.

## Opportunity and risk analysis

The first step is therefore to analyze the key trends affecting a company as well as the opportunities and risks that arise from them in factual, regulatory or even social terms. One global trend that will shape businesses' operating environment going forward, for example, is demographic change, whereby population growth and aging have further consequences and impacts on other global trends. Those can be seen in areas like healthcare, retirement planning and even in cultural transformation between the generations. That impacts business models in different industries. Companies in the pharmaceutical, life science, financial and insurance industries need to think about what this trend means for them.

Businesses play an important role in efforts to solve global challenges and their autonomous endeavors could be pivotal to overcoming those challenges. The current mindset is based much less on purely ethical considerations than it is on a more comprehensive understanding of the relationship between cause and effect as well as the importance of social and environmental factors on a business's long-term success.

#### Focus on climate change

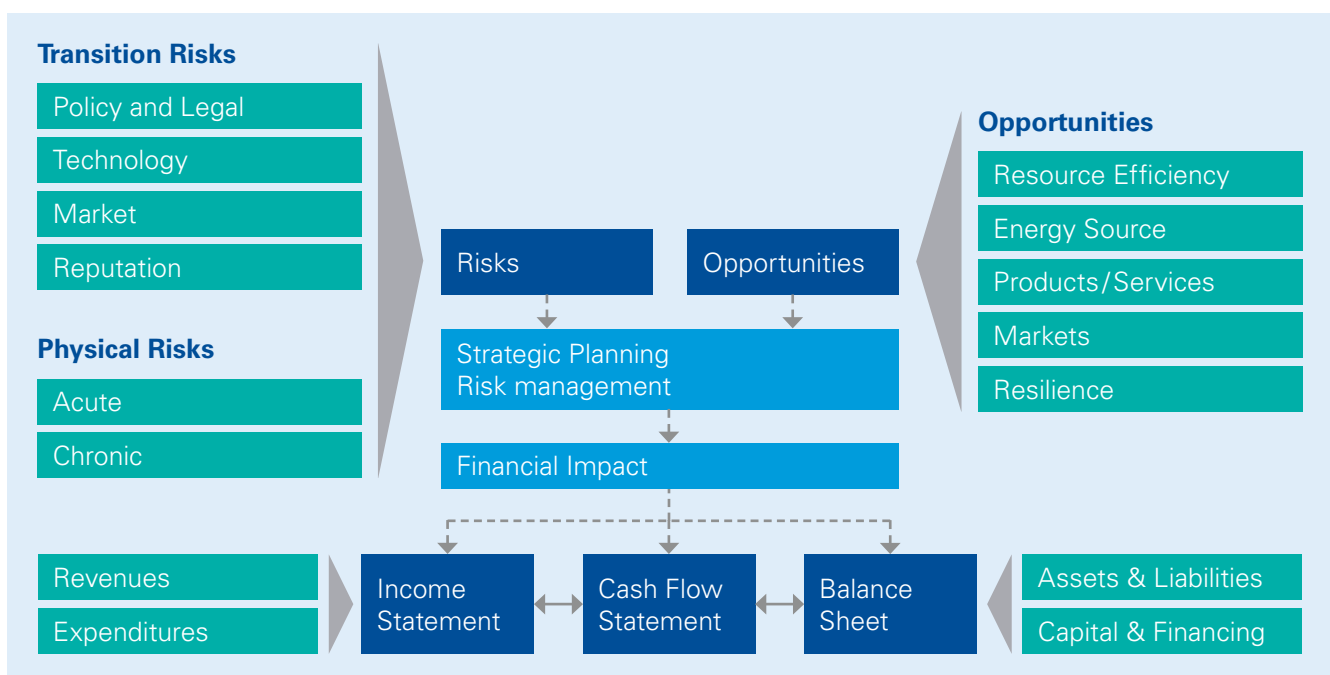
Special attention is currently being given to environmental trends, with the topic of climate change playing a particularly prominent role. This topic is giving rise to a panoply of opportunities and risks for businesses including new regulations, market shifts and interrupted supply chains. It also impacts other environmental aspects such as biodiversity and water availability, to name a couple of examples. Depending on which future scenario comes to pass, the characteristics of such opportunities and risks vary. If the ambitious political objectives of the Paris Agreement are achieved, this will result in a significantly different set of transition risks. In that case, it could be expected that the price of carbon would be substantially higher, which would have a correspondingly negative impact on fossil-energy-based business models. By contrast, more physical risks would be expected in a business-as-usual scenario, which could negatively impact factors like supply chain resilience. Each respective scenario results in various further social and environmental

developments that are relevant to the company in specific ways. This calls for growing awareness among investors and businesses that these changes can impact their financial position, significantly in some cases.

#### Sustainable realignment of business models

How can businesses respond to these long-term trends and the resulting opportunities and risks? The answers to this question are many and varied. They range from employee development to integrating aspects of socially relevant issues into the innovation process to building resilient supply chains. At the end of the day, this can all be collectively referred to as a sustainable realignment of business models. The timing has never been better. Not only is the pressure coming from regulatory authorities and investors growing, but it can be assumed that the COVID-19 pandemic will have a lasting transformative impact on numerous industries. Plans by the EU, US and other nations to harness this momentum and invest in sustainable infrastructure projects will open up one-of-a-kind opportunities for those businesses that are able to adapt.

## Climate-Related Risks, Opportunities, and Financial Impact



# Regulators' and investors' requirements on the rise

## Focus on transparency: sustainability reporting

Businesses are rethinking their business models and new, innovative companies are addressing social needs. Hasn't that always been the case? Corporate reporting reflects the heightened relevance of sustainability, but where is it coming from?

It should be stated at the outset that large businesses, in particular, have long since been aware of these global challenges and both measure and communicate their non-financial performance as a basis for appropriately managing risk and to steer their own transformation. Their enormous dependency on social and environmental capital as well as on a broad circle of stakeholders – in addition to their investors – shaped reporting early on and has grown strongly over the past few years.

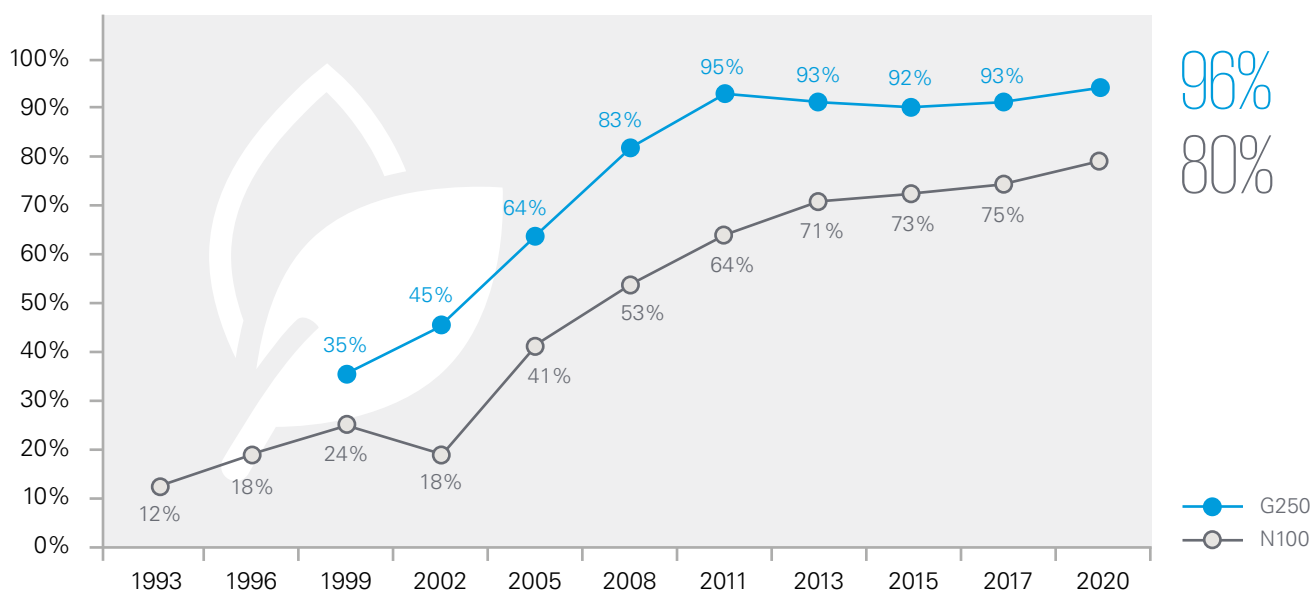
One relatively new aspect is heightened interest on the part of investors and regulatory authorities, which has boosted momentum globally. Not only are we seeing mounting scientific evidence revealing a connection between how businesses handle ESG topics and their financial success, as

mentioned above, but there is also a growing consensus that global risks like climate change, for example, could have a major impact on the financial performance of financial institutions' portfolios and on the global financial system; this insight, however, has not found its way into traditional financial reports or, if so, only to a limited extent. On the topic of "stranded assets," estimates reveal that, when looking at the major stock markets, the value at risk from climate change could amount to between USD 4-43 trillion<sup>1</sup>. The value at risk from the potential global loss of biodiversity is estimated at up to USD 44 trillion. Of course, investors want to and have to understand the risks they're dealing with. It is also becoming apparent that especially the younger generation – the investors of the future – is increasingly bringing moral issues to bear when making investment decisions. This has resulted in a correspondingly strong uptick in demand for sustainable investments in the recent past. The value of sustainable investments in Switzerland amounted to CHF 1.163 trillion in 2020, up 62% over the previous year<sup>2</sup>.

<sup>1</sup> The cost of inaction, The Economist

<sup>2</sup> Swiss Sustainable Investment Market Study 2020

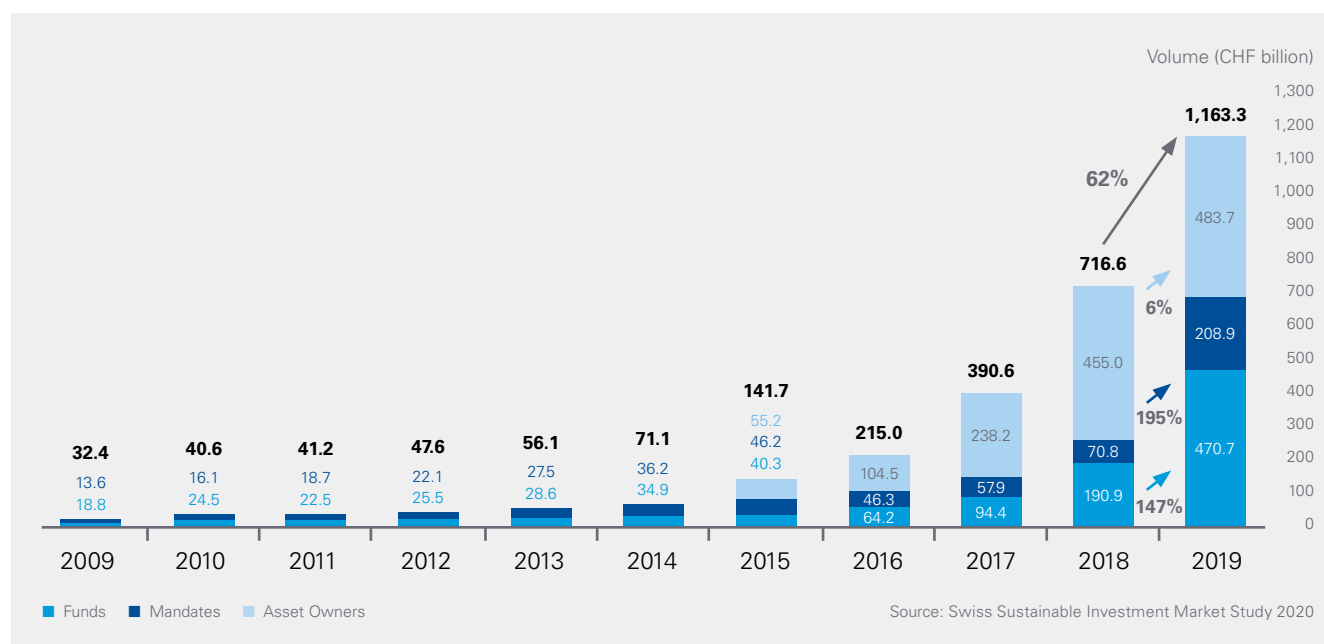
## Growth in sustainability reporting



Source: The time has come (KPMG 2020)

## Development of Sustainable Investments in Switzerland

(in CHF billion)



In his letter to CEOs, Larry Fink, CEO of Black Rock, highlighted the priorities on behalf of the entire financial industry: "No issue ranks higher than climate change on our clients' lists of priorities. They ask us about it nearly every day."

To manage their own risks and make sustainable products possible, financial institutions have invested heavily to integrate ESG aspects into their investment decision-making processes. This then triggered growing demand for information on those aspects, which businesses are feeling. Demand is growing rapidly for the companies themselves to provide comparable, reliable and specific information. Because every company is positioned differently. The fact that supply chains, customer structures and a company's own service provision can even differ within one and the same industry also gives rise to different opportunity and risk profiles. As a result, investors want to understand precisely which risks arise for a specific company on issues like child labor and climate change, for example. Which transition risks does a company face if political objectives related to carbon neutrality become a reality? What financial impact will higher carbon prices or changing technologies have on the affected organization?

### Regulations and obligations on the rise worldwide

With regulatory developments strengthening the trend, lawmakers are putting a special focus on the topic of transparency. Globally, there has been an increase in disclosure requirements for several different non-financial

issues<sup>3</sup>. Ever since the vote on the Responsible Business Initiative in 2020, businesses in Switzerland have also been finding themselves faced with the prospect of mandatory disclosure regulations on non-financial issues. A non-financial report must be prepared for public-interest entities with more than 500 employees and a certain financial size that cannot be exempted for reasons provided for by law.

While the law governs the details, it was largely aligned with current legislation in Europe and includes issues in the areas of environmental matters, social and employee-related aspects, anti-corruption and respect for human rights. Certain companies are additionally subject to due diligence and transparency obligations with respect to minerals and metals from conflict areas as well as child labor.

The effects arising from the interplay of foreign regulatory requirements and the impact of these on investors' end have now become at least as relevant for Swiss businesses, particularly for those with an international focus and dependencies on the capital market. One case study on the matter is offered by the European Union's Green Deal and the Sustainable Finance Action Plan, which forms a part of the Green Deal and aims to help redirect needed investments into sustainable development. Among other things, this has resulted in provisions designed to enable investors to incorporate the necessary information into their analyses and marketing in a comparable and reliable manner.

Of particular note is the EU Taxonomy regulation, which defines the first-ever uniform classification system for

<sup>3</sup> Carrots & Sticks

sustainable economic activities. It sets out sustainability requirements for economic activities and investments in those activities. If they are then packaged into financial products, offered to investors and advertised accordingly, the EU Taxonomy regulation defines transparency requirements for corresponding financial institutions. On the other hand, (industrial) companies in the EU that had previously been subject to non-financial reporting requirements within the scope of the Non-Financial Reporting Directive (NFRD) must disclose the share of these activities with respect to their revenue, capital expenses and operating expenses and operating expenses. A necessity, in part to make it possible for financial institutions to make mandatory disclosures regarding the share of sustainable investments contained in their portfolios. In that sense, it creates a common language and will probably become a very important indicator for reporting.

The European Commission additionally published plans in April 2021 in the context of the Corporate Sustainability Reporting Directive (CSRD) that would greatly extend the scope of companies included, mandatory reporting

standards and audit requirements. The objective of all these activities is clear: to improve the comparability, reliability and usability of the information shared with readers, and investors in particular, so that they can make investment decisions efficiently. This discussion has also reached Swiss businesses. Swiss groups with subsidiaries in the EU must assess whether they will be impacted by the newly proposed CSRD. The new EU regulations also affect Swiss financial institutions, which will have to have their information requirements met by Swiss companies, as well.



# Reorientation of non-financial reporting

## Trends in corporate reporting

To date, many companies, especially larger ones, have provided reports on their non-financial performance in a structured and mostly voluntary manner. Some 80% of Switzerland's 100 largest companies have sustainability reporting frameworks<sup>4</sup>, with three out of four of these companies indicating that they geared their report to the GRI Standards. While GRI is still the dominant standard worldwide, numerous other standards and frameworks exist such as SASB, IIRC, the GHG Protocol and TCFD, just to name a few.

According to initial proposals, the current, comprehensive standards as well as the group working to develop future

EU standards (EFRAG) are generally geared toward a three-category approach referred to as ESG reporting. The thematic content of an ESG-type report (E for environmental, S for social and G for governance) can be seen in an example taken from the EFRAG proposal.<sup>5</sup>

Pressure to include a larger amount of and more reliable information is increasingly being accompanied by a shift away from the voluntary approach. A growing number of states or associations of sovereign national states are

<sup>4</sup> The time has come, The KPMG Survey of Sustainability Reporting 2020

<sup>5</sup> European Lab – Project Task Force on Preparatory Work for the Elaboration of Possible EU Non-financial Reporting Standards – EFRAG

## What are E, S and G?



### «Environment»

Category (E)

✓	Climate change
✓	Water and marine resources
✓	Biodiversity and ecosystems
✓	Circular economy
✓	Pollution



### «Social»

Category (S)

✓	Workforce
✓	Value chain workers
✓	Affected communities
✓	Consumers and end users



### «Governance»

Category (G)

✓	Governance
✓	Business and ethics
✓	Management of the quality of relationships with stakeholders
✓	Organization and innovation
✓	Reputation and brand management



raising their requirements and introducing mandatory reporting rules. The example of how these are being developed in the EU reveals which problems have been identified in previous reporting systems and which solutions this will tend to lead to.

The information companies had previously been reporting was often insufficient. While information that investors considered relevant frequently went unreported, some of the information being offered by companies was deemed immaterial. Comparability of information is still often limited, in part because of the numerous different standards that exist and are applied. In many instances, the quality of this information is also being questioned since it is often based on less robust processes and rarely subject to audit requirements.

On 21 April 2021, the European Commission published new legislative proposals within the context of the EU's Green Deal, including the Corporate Sustainability Reporting Directive (CSRD). It greatly extends the scope of companies included and subject to reporting requirements, which is also likely to impact Swiss businesses with subsidiaries in the EU. It also includes an audit requirement. With respect to the content of the reporting obligations and/or the future reporting standard, the European Financial Reporting Advisory Group (EFRAG) is working on drawing up a corresponding proposal on behalf of the European Commission. This journey's precise destination is explained in the report entitled "Proposals for a relevant and dynamic EU sustainability reporting standard setting".

Businesses are to adequately depict the repercussions of their economic activity at three levels: sector agnostic, sector specific and entity specific.

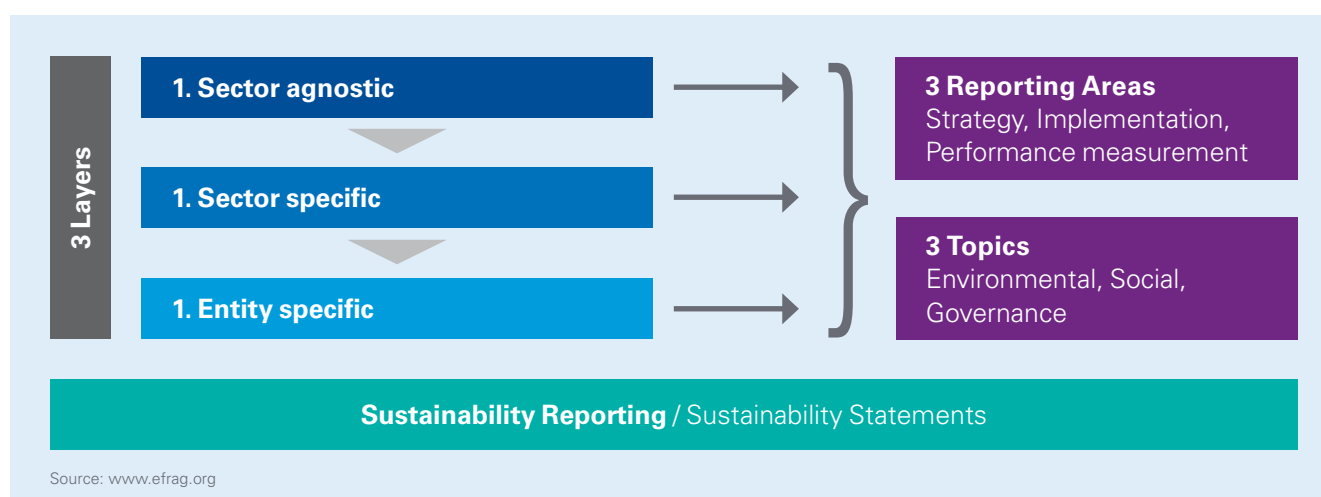
The idea behind this is that a general set of information must be equally applicable to all companies in order to ensure comparability across sectors, but that sector-specific

and individual information should also round out the picture and, in doing so, enable an entity-specific assessment. To a certain extent, this represents a departure from the rather flexible structure of the GRI Standards.

Another important element is the concept of double materiality, which will still be fleshed out further. This is being done to show both the impact on sustainability-related topics, such as how the entity's operational activities negatively impact the environment (impact materiality), as well as the financial impact of changes to the entity's environment, with one example being climate change, even if these changes only manifest in the future. To that end and compared to past reporting approaches featuring a strong focus on the entity's footprint, sustainability reporting is increasingly being supplemented by a forward-looking risk perspective designed to explain to investors how the company's risk profile is changing.

A stronger focus on the future is also being encouraged. This can, or should, be achieved by consistently aligning objectives with scientific findings and international agreements. Science-based targets help a business focus on the main policy thrusts and show investors where the business stands with respect to implementation and/or the strategic realignment. In the case of the CSRD, that also includes linking it to the Taxonomy regulation, which offers science-based thresholds. This is also why many observers expect taxonomy disclosures to become one of the most important ESG indicators.

It is becoming increasingly clear that non-financial reporting, financial reporting as well as the management of corresponding issues should and must grow together. EFRAG is also demanding that these be linked more closely.





# Which conclusions can be drawn for boards of directors and top management?





Reporting on non-financial issues is no longer a voluntary exercise, rather an obligation. Not only are businesses increasingly finding themselves faced with legal requirements, but pressure from investors is essentially making this an obligation if they want to safeguard their access to financing. Corporate communication on sustainability-related topics will have to become more professional and both governance as well as the structures of the systems surrounding the reporting process will have to be strengthened – changes that are both imperative and just a matter of time. Boards of directors and top management need to be aware of the fact that as the relevance of disclosed information grows, so do the legal and reputational risks. They are responsible for ensuring that investors are provided with appropriate, reliable information. And also, that an appealing equity story is presented that shows how the company can profit from opportunities that arise in connection with social challenges and governmental funding programs and how it addresses global risks.

Reporting on sustainability is only one side of this, however. A company's operations first have to be realigned with a focus on sustainability before it can successfully communicate that focus. In light of the political objectives defined for numerous sectors and their increasingly concrete targets, like those seen in the EU Taxonomy regulation, for example, rapid action is required. Targets such as these form the basis for future ratings, benchmarks and investment considerations for pension funds, asset managers and banks. Achieving them will hinge on far-reaching measures and investments in both infrastructure and expertise. A transformation that will not happen overnight.





