Doing business in the EU

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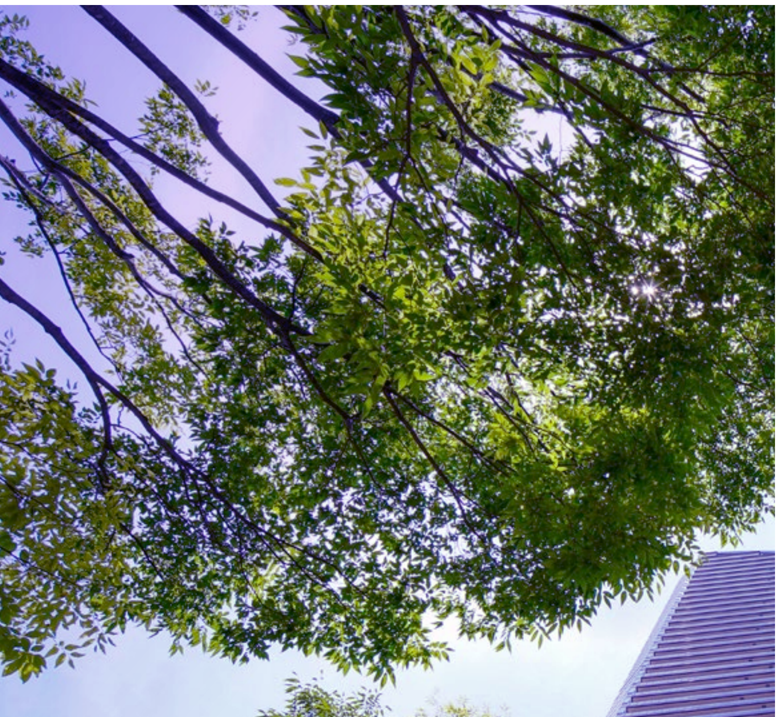
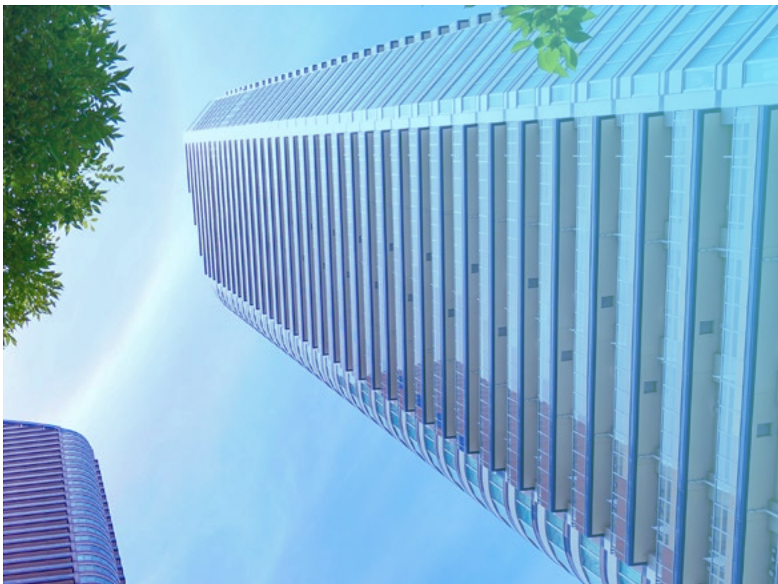
New challenges on the horizon in a changing business context

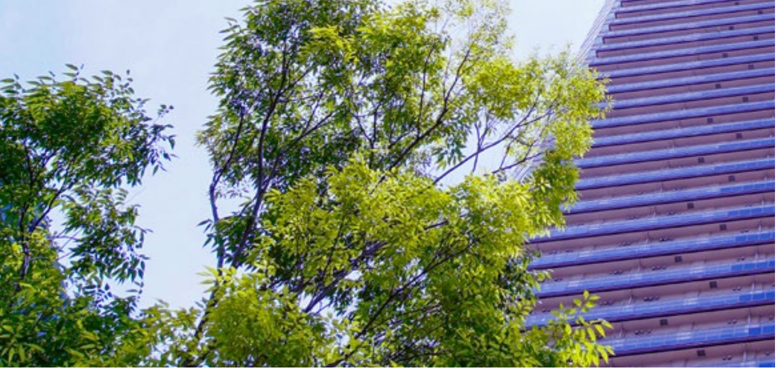
The European Union (EU) is an important – and in fact the largest – trading bloc globally. Consequently, it has a considerable impact on third countries and, by extension, on aspects like environmental and social development. The ties between the EU and Switzerland in the fields of trade, politics or science have also been strong and important, for both sides. More than half of Swiss foreign trade is conducted with the EU, while over half of Switzerland's exports go to the EU and two-thirds of its imports come from it. The rules that the EU sets for its products, companies and trade in general often become a baseline expectation, if not law, in Switzerland, too, even if some would like to believe otherwise.

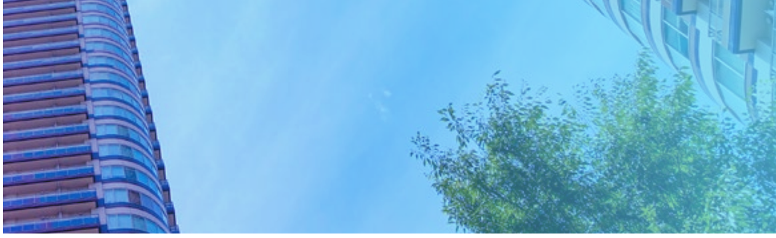
The EU Green Deal

With the Green Deal, the EU has set the course to change the economic system in the EU profoundly. Legally binding targets for emission reduction and climate neutrality provide the basis for a broader roadmap, which strives for a modern, resource-efficient and competitive economy. It contains policies in the realms of climate, energy, transportation and taxation and offers a vast amount of incentives for companies to change. Huge public and private investments are needed to transform agriculture, transport, industry, research and innovation as well as the financial industry. The Sustainable Europe Investment Plan expects more than a EUR 1 trillion in public and private investment over the next decade, presenting a huge opportunity for companies willing and able to change. It shows that politics is getting serious about what are known as "externalities". Externalities have









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existed for as long as business itself. Throughout history, companies have created benefits for society for which they have not been fully compensated (positive externalities) and have also imposed costs on society for which they have not fully paid (negative externalities). The effects of negative externalities such as plastic pollution, carbon emissions and ecosystem damage are becoming impossible to ignore and have been explicitly recognized by the EU. Taxing such undesired impacts or even banning materials is increasingly a means to change behavior and it impacts the business context of certain companies significantly.

This transformation might be very costly. First, because changing strategies and business models will not be easy in general and new taxes might be very burdensome. Second, because one central element of the transformation roadmap of the EU is just in the starting blocks. Financing the transition requires clear rules within the capital market. Stakeholders are asking:

- What constitutes green?
- How can investment in environmental friendly practices be encouraged?
- How can investors obtain decision-relevant information?

These are the kind of questions that shaped the action plan to finance sustainable growth, to support the Green Deal. Transparency considerations are particularly relevant when pursuing the Green Deal’s goal to reorient capital flows toward sustainable investment and to manage financial risks stemming from climate change and resource depletion. Proper action and governance by financial and corporate actors is needed to understand and mitigate the risks related to ESG factors which may have an impact on the financial system.

Corporates can initially expect two particularly significant impacts arising from the regulatory action plan – additional items may follow later.

The EU Taxonomy

The EU Taxonomy’s objective is essentially to define what is “sustainable” or “green”. It is a classification of economic activities using science-based criteria. It is to provide companies, investors and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable and can be seen as a common language in which various capital market participants will be interacting to communicate about their products, operations and strategies. As companies need to disclose their revenues, capex and opex in alignment with the set criteria, a significant effort will be needed to produce such KPIs, at least initially. In the EU, for companies reporting under the Non-Financial Reporting Directive (NFRD), it is already a mandatory rule to adhere to.

In addition, and even more importantly, the Corporate Sustainability Reporting Directive (CSRD) entered into force in January 2023. This new directive defines new rules about environmental, social and governance information that companies have to report. A broad set of large companies within the EU are affected. In contrast to the previous rules under the NFRD, the qualification as a public interest entity will no longer be relevant. The new rules will mean a huge extension in the scope of companies affected and topics to be covered. It also means a major increase in complexity, as companies will need to consider new concepts, like the double materiality assessment, due diligence, information about the value chain, Taxonomy KPIs etc. It means companies may need to report on a staggering amount of data in the future.

As the Taxonomy is already relevant for some companies in the EU, we are beginning to see signals of change. The first reports have been published. Growth in sustainable investments has picked up and the appetite for more reliability, expressed in higher assurance rates, is also a sign of the approaching regulatory wave.

What is the bottom line? The business context for companies operating on the European continent and those of relevance in the supply chain is set to change in an unprecedented way.

So what should Swiss companies and boards take away from it?

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1. Switzerland is not a "transparency" island

Switzerland sets its own rules, be that in the area of environmental protection, social aspects or transparency. Recently, Switzerland introduced new rules on non-financial (ESG) reporting, as well as due diligence aspects, to name just two of the most prominent ones. However, adhering to these rules alone will not help players retain access to the EU markets.

First of all, this is because the new rules in the EU directly affect the larger subsidiaries of Swiss groups. This is basically true for all laws in the EU. However, in this case it is particularly troublesome since the EU requirements in the fields of reporting (CSRD/ESRS) are so vast. It would be a great relief and also cost-efficient to allow delegation to the ultimate parent, as we already know from consolidated financial statements drawn up in accordance with IFRS. However, in contrast to the financial area, it is relevant to understand that the Swiss rules are currently not aligned and most probably not seen as "equivalent". This means subsidiaries can only avoid an additional burden by delegating those tasks to their ultimate parent company if the parent itself complies in full with the new EU rules in addition to what it already does to meet Swiss requirements. A recently published report and statement by the Federal Council acknowledged that this inconsistency is undesired and not conducive to Switzerland's objective of being a leader in sustainable finance and transparency. The Federal Council announced that further alignment can be expected.[1]

Further, groups with non-EU ultimate parent companies will have to comply with the CSRD and provide consolidated sustainability reports if they generate net turnover of more than EUR 150 million on average and have at least one subsidiary or branch in the EU. So it may be assumed that almost any larger Swiss group – private or public – with a footprint in the EU will be directly hit by the EU regulation

[1] Sustainable Corporate Governance: Federal Council defines further course of action (in German)

and will report under the CSRD including the EU Taxonomy. Whatever solution the Federal Council comes up with, it can be hoped that a pragmatic approach is found to ease the burden for companies.

But even for companies not directly in scope, entities within their group will probably be affected by the change, as will other relevant stakeholders such as investors or customers. Switzerland is not an island and will most likely be part of the change. Transparency is the price for retaining access to the EU market.

This is also true beyond the corporate reporting space. The Carbon Boarder Adjustment Mechanism (CBAM), for example is designed to function in parallel with the EU ETS which encourages high-emission industries in the EU to reduce emissions. To avoid the risk of carbon leakage arising from the removal of the free ETS allowances and basically to penalize a potential shift from carbon-heavy emissions out of Europe, CBAM imposes a charge on the embedded carbon content of certain goods upon their importation into the customs territory of the EU. This is equal to the charge imposed on domestic goods under the EU ETS. To be compliant, companies will need to understand the carbon footprint of their products, report this to the relevant authorities and have their lifecycle assessment assured.

Those are just a few examples of how EU transparency requirements and ambitions to address externalities will affect Swiss companies. The cost of complying will be significant in many cases – but the costs of inaction might be even higher.

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2. Robust data is the new gold

Non-financial aspects have played only a limited role in steering the performance of a company in the past despite the fact that intangibles like brand or client relationships have become relevant assets. Non-financial impacts of a company, which do not positively or negatively translate into P&L impacts – so-called "externalities" – have come at none or limited costs. Dependencies on scarce resources have not materialized significantly until only recently. This has led to reporting and performance frameworks being largely based on financial value creation and figures. Traditionally, non-financial information has often been neglected and has not enjoyed the same priority as financial information.

Now, data at the corporate and product level is becoming relevant and legally required. To retain market access and satisfy the needs of major stakeholders like employees and customers, reliable information on non-financial data will be key. However, it is at present often unavailable or of insufficient granularity. Companies seldom know and understand their full exposure to externalities and dependencies. Would you know how much you pay in plastic tax or what your exposure is with regard to changes in carbon tax schemes? Certainly, many were taken by surprise by the most recent supply chain disruptions. This shows that companies do not yet have mature enough transparency and understanding of their value chains.

In order to stay competitive, this will need to change, certainly for the larger Swiss groups with a footprint in the EU. The main takeaway here is that ESG is just one part of the game. The other is digitalization and the data challenge. Companies will need to have a plan for both.

3. Structure follows strategy

Looking at the vast regulation in the reporting area, it can be tempting to think that transparency is the main challenge. Re-defining reporting and systems will take some effort, no doubt. Changing structures in these areas will be unavoidable in many cases and will also rely on strong leadership from the top. However, to achieve the goals of the Green Deal, real transformation needs to take place. Amid shifting business parameters like taxes and incentives; growing risks from scarce resources; and changing consumer mindsets, companies will be forced to start changing business models and strategies. Producing carbon-neutral, circular products will demand transparency, data and new approaches, all of which will affect business partners, customers and operations. Change will be profound and, again, the benefits of starting early seem to be compelling.

Such plans will need to be solid and supported by appropriately robust financial planning as companies will be required to provide transparency toward their stakeholders – in particular investors – on such plans.

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What should boards consider?

Boards of affected Swiss companies play a crucial role in driving change. This is incidentally also reflected in the spotlight that both the amended Swiss Code of Obligations and the CSRD put on boards by assigning them new tasks. Among other things, the CSRD specifically mentions the audit committee and its role in monitoring the sustainability reporting process, including the digital reporting process, and the process carried out by the company to identify the information reported according to the relevant sustainability reporting standards. The audit committee is asked to monitor the effectiveness of the company's internal control and risk management systems and, where applicable, its internal audit, with respect to the sustainability reporting of the audited entity. It should also monitor the assurance of the annual and consolidated sustainability reporting.

However, the board's most important task will be to not lose sight of the bigger picture. And this is the ultimate change in the business landscape as a whole. This is why the company's strategy and governance need to be reset in order to tackle the associated challenges in the short, medium and long-run.

By now it should be clear to all boards that there is no way around the new rules of play. Early adapters will have a huge opportunity to win market share, while laggards stand to lose. It also highlights once again that the ESG challenge is not merely a matter of environmental, social and governance topics but needs to be coupled with a suitable digital strategy and roadmap. Board leadership is now what's needed most.

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