Sustainability reporting – reliable and dependable

Companies in the EU are facing a wave of ESG regulations, which in turn are increasing requirements around transparency and data quality. Hopes that regulatory pressure will subside will likely prove illusory. In practice, the trend is moving in the opposite direction: requirements are increasing, not decreasing. From more detailed reporting to mandatory due diligence, companies must adapt if they are to not only meet legal requirements but also safeguard their long-term competitiveness. Boards of directors are called upon to show leadership and actively shape the transformation.

"Today we are in the midst of a rapid global transformation…Climate change; community health, education and development; and business sustainability are some of the most pressing issues of our time." What could easily be read as a commentary on current changes in how companies report and align their business is, in fact, a quote from the introductory remarks by Lord Michael Hastings, Global Head of Citizenship and Diversity, in KPMG's global study on corporate responsibility reporting from 2008.

The global transformation is in full swing, but has by no means taken place at the predicted speed. Although the energy transition is making its mark in many areas in Europe, emissions continue to rise globally. According to the International Energy Agency (IEA), energy-related emissions continued to rise in 2023, contrary to the reduction needed to limit global warming to 1.5 or 2 degrees Celsius.

2030 Emissions Gaps

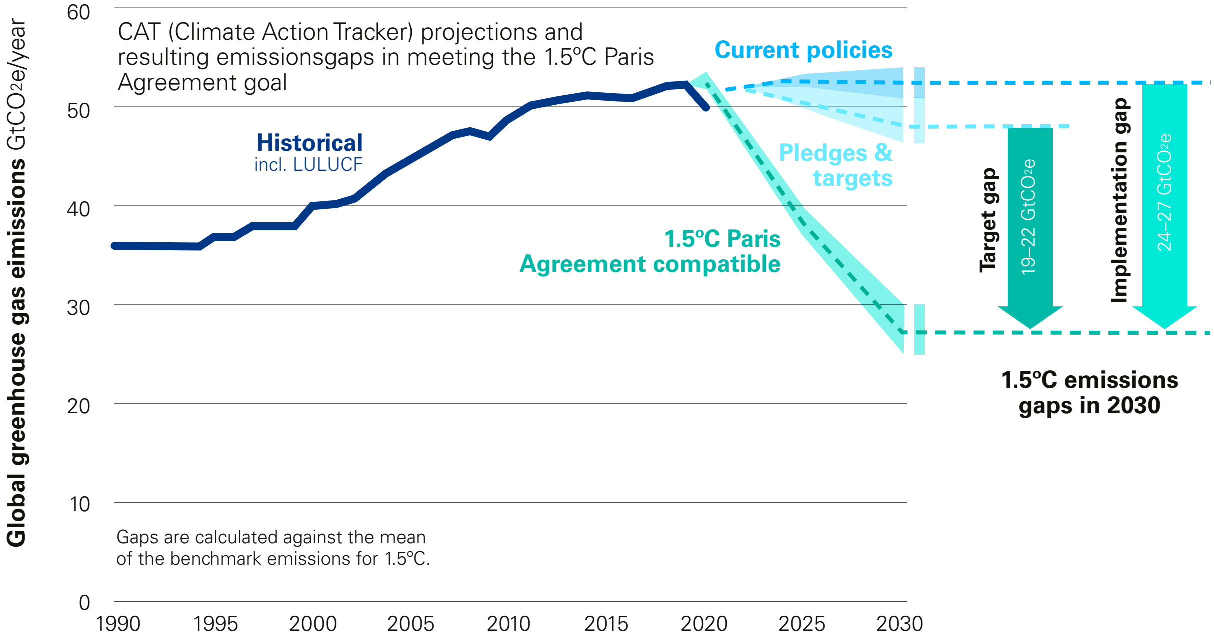

Figure 1: CAT Emissions Gaps[1]

Developments in the areas of **biodiversity** and **human rights** are similar: improvements are being made, but not at the pace that would be necessary to achieve the goals that have been set. Pressure is mounting on policymakers and industry to act.

At least there seems to be noticeable progress in **reporting practices**. While just 28% of companies in Switzerland published a separate sustainability report in 2008, that figure has now risen to more than 90%. However, on closer inspection, it will be clear to many that, in the absence of standards, these reports are often not comparable and therefore have little relevance for investors. Since only some of the information contained in them is subject to assurance, the reports are not considered reliable either. In this context, the European Commission has identified a need for action in the area of sustainability reporting. As part of the Green Deal announced in 2019, an improvement in transparency, particularly in the areas mentioned, was also addressed as part of an overall package to achieve the environmental and social goals set. The Corporate Sustainability Reporting Directive (CSRD) has now been enacted and the first companies will have to comply with the new regulations as early as 2024. Many large, and usually listed, Swiss groups will follow in the second wave from 2025. The CSRD requirements are comprehensive and require companies not only to provide information about their impact on people and the environment along the entire upstream and downstream (!) value chain, but also to provide tangible information on the financial and strategic impact of megatrends, such as climate change or biodiversity loss, on the company. Given that there are more than 1,000 data points to choose from and potentially report on, it's a Herculean task.

[1] CAT Emissions Gap

In Switzerland, if the Federal Council has its way, the trend will continue in the same direction. Their recently published consultation[2] seeks further alignment with European and international law. The proposal is noteworthy in two respects. The Federal Council would like to see not only listed companies but also economically significant companies[3] required to report in future. All companies would be required to report in accordance with the comprehensive provisions of the CSRD (or an equivalent standard).

Other regulations, particularly in the EU, have a reinforcing effect and go beyond reporting. For example, the Corporate Social Due Diligence Directive (CSDDD) links comprehensive due diligence requirements with reporting. These mandatory human rights and environmental due diligence requirements extend to the company's entire "chain of activities" and cover both upstream and downstream business partners.

In view of these extensive and detailed regulatory proposals, particularly in the EU, skepticism is increasingly being expressed by some stakeholders. These voices advocate for sustainability, but also for less regulation and greater personal responsibility.

Fours emerging trends

Regardless of skepticism and headwinds, some trends in sustainability and ESG reporting are now clear to see.

1. Regulation is increasing, not decreasing

There is little reason to hope, at least in the short term, that policy intervention in the area of ESG will decrease anytime soon. On the contrary: there has been a clear increase in regulatory activity in recent years, with a particular focus on transparency regarding environmental and social issues. However, the effectiveness of these measures has yet to be demonstrated. Often, the interventions were also the result of mistakes due to a lack of personal responsibility. One example of this was the initially voluntary implementation of the Guiding Principles on Business and Human Rights in Germany. A first survey carried out in 2019 was completed by only 400 out of more than 3,000 companies contacted. The analysis revealed that only 20 percent of these 400 companies met the requirements of the National Action Plan for Business and Human Rights. A year later, the results were similarly poor, leading to the enactment of binding regulations in Germany in the form of the Supply Chain Act ("Lieferkettengesetz").[4] A wait-and-see approach or inadequate fulfillment of certain expectations can therefore have undesirable knock-on effects.

[2] Nachhaltige Unternehmensführung: Bundesrat schlägt strengere Regeln für Berichterstattung vor (admin.ch)
[Sustainable corporate governance: Federal Council proposes stricter rules for reporting]

[3] Companies that reach two of the three following thresholds in two consecutive years: 250 employees, CHF 25 million in total assets and CHF 50 million in revenue.

[4] Hintergrundinformationen: Lieferketten und Lieferkettensorgfaltspflichtengesetz | BMZ
[Background information: Supply chains and the Supply Chain Due Diligence Act]

The trend is clearly moving toward greater regulation and the introduction of binding standards and audit requirements, as evidenced, for example, by the latest consultation draft of the federal government.[5] This is currently true in Europe more than in the rest of the world.

Cumulative number of policy interventions per year

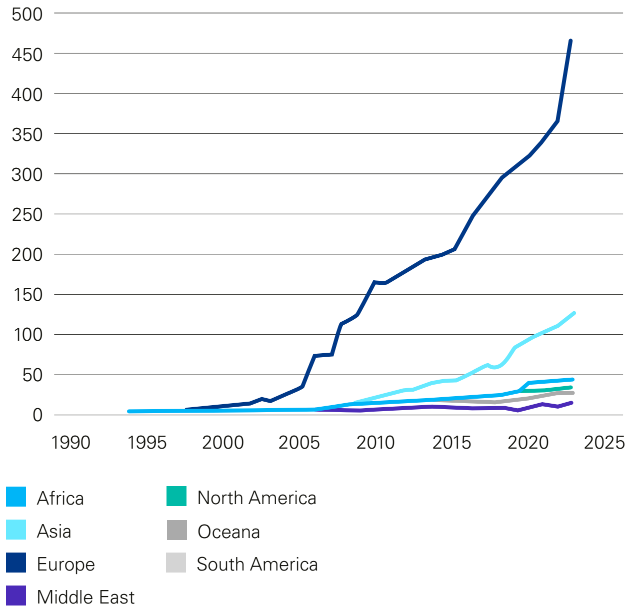

Figure 2: Annual policy interventions per year relating to responsible investment, by continent[6]

2. Demand for more comprehensive and detailed data

Enhanced reporting on selected non-financial matters is a clear focus of legislators in Switzerland and the European Union, in particular to provide capital market participants with sufficient information on a company's risk profile and positioning. Management and boards of directors of listed companies are already well aware of the requirements for corporate reporting. Climate reporting and non-financial reporting have also arrived in Switzerland. These requirements apply beyond the scope of companies already mandated by law – 90% of the largest 100 companies in Switzerland now report publicly on environmental and social aspects, regardless of their access to capital markets. However, more extensive reporting requirements are not yet evident in many cases, partly because certain regulations will only become tangible in the near future. However, data and information must already be available not only at the company level, but also with regard to products and supply chains. The Carbon Border Adjustment Mechanism (CBAM), packaging regulations and EU Taxonomy – all demand that information be available at a much more granular level in order to manage relevant aspects and be able to meet legal requirements.

3. Actual performance and intentions will become clearer

New legislation means that more data will be standardized, available in higher quality and in digital form. This makes it easier to compare actual performance – and pressure increases. EU regulations such as CSDDD go beyond the mere transparency efforts of the CSRD and explicitly require the adoption or implementation of measures as part of a transition plan. This subjects companies and their boards of directors to increased legal risks. In the near future, simply announcing targets will no longer be enough – 80% of Switzerland's largest companies have already set such targets, often with a scientific basis (e.g. Science-Based Targets Initiative (SBTI)). The CSDDD requires companies to implement their climate transition plans in a more proactive and comprehensive manner, which may also affect small and medium-sized companies in Switzerland due to the business relationships they maintain as part of the supply chain. In the foreseeable future, it will therefore be standard practice for large companies, especially in the EU, to not only report professionally, but also to have credible plans in place to address urgent issues, such as their own impact on climate change. Similar developments can be expected in the area of human rights.

[5] Nachhaltige Unternehmensführung: Bundesrat schlägt strengere Regeln für Berichterstattung vor (admin.ch) [Sustainable corporate governance: Federal Council proposes stricter rules for reporting]
[6] 88 new policies added to PRI's regulation database | Blog post | PRI (unpri.org)

4. Transformation needs leadership: the board must take ownership of this task

There is currently a lot of momentum in the sustainability space. In practice, a high degree of diversity is observed in how the transformation is being managed. The current focus is often still on reporting and its credibility and only rarely on holistic transformation and effective management of strategic objectives. Yet, many of the changes are fundamental and are progressing independently of regulation, for example, in the areas of energy supply or mobility. What is needed now is genuine leadership. Not only to meet the regulatory challenges appropriately, but also to address the risks and opportunities of the current changes in the business environment in a targeted way. Few companies have already identified potential for new business or are pursuing sustainability as a real differentiator, according to a recent study by the Institute of Financial Services (IFZ) at the Lucerne University of Applied Sciences and Arts.[6]

[6] ESG-Reporting-Studie-2024.pdf

Conclusion:

What does this mean for boards of directors?

Companies are currently undergoing a period of fundamental change. Geopolitics, the global economy and worldwide challenges such as climate change and the loss of biodiversity are affecting policy, markets, technology and other aspects. Clear direction, prioritization and leadership are therefore essential – and the responsibility of the board of directors. Complying with legal requirements is only the basis for a company's "license to operate". It's implementing credible and effective projects that makes the difference and truly adds value. The time for intentions is over – now it's time for action.

Your contact

Silvan Jurt
Partner, Head Corporate Sustainability Services
KPMG Switzerland

+41 58 249 50 25
sjurt@kpmg.com

This article is part of KPMG's Board Leadership News.

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