Sustainability

Recent developments in Europe prompt a need for boards of directors to take action

The importance of a sustainable business has been common knowledge for some time now and many countries, including Switzerland, have pledged their commitment to sustainable development through the 2030 Agenda. The European Commission announced its European Green Deal in 2019 with the goal of making Europe the world's first climate-neutral continent. While companies have been able to opt between different frameworks to fulfill their (disclosure) obligations in the past, the latest developments seem to amount to detailed requirements by the European Commission. That being the case, close attention must be paid to these initiatives, especially since it can be assumed that they will have at least an indirect impact on Switzerland.

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Introduction

For many companies, sustainable business activities has been a matter of course for some time already. And the fact that today's consumption cannot be allowed to burden future generations is also undisputed. With its 2030 Agenda, the UN has unified its efforts at the global level to both promote sustainable development and eradicate poverty and has also defined 17 Sustainable Development Goals (SDGs) to that end. Politicians are not the only ones who are busy coming up with ways "to encourage non-governmental actors to make an increasingly active contribution to sustainable development". NGOs in Germany and Holland just recently won court rulings that will require companies to operate sustainably.

Much of this, however, is nothing new. Gro Harlem Brundtland penned a report back in 1987 entitled "Our Common Future", in which he laid down the principles of a concept that specialist publications later referred to as the triple bottom-line approach. In addition to the economic dimension of sustainability, businesses should also consider the environmental and social dimensions of sustainability in equal measure. Just a few years later, Archie B. Carroll published a trailblazing paper entitled "The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders". This paper offers a diagram that distinguishes between four different levels of corporate social responsibility that build on one another while also anticipating a fact that is undeniable in today's world: the importance of conducting business in a compliant manner. The Carroll pyramid linked the topics of corporate social responsibility (CSR) and compliance 30 years ago and with enormous foresight.

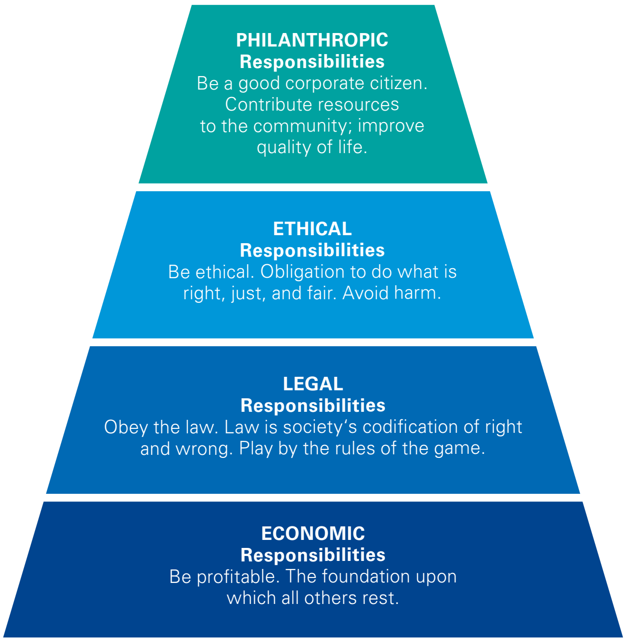

Fig. 1: Carroll pyramid (p. 42, Carroll, 1991)

While NGOs have been pointing out for many years that not enough attention is being paid to sustainability-related issues around the world, this has been changing in Europe as implementation of the 2030 Agenda progresses. On that note, it’s worth taking a few moments to briefly examine developments in Europe and analyze their impact on Switzerland.

Repercussions on risk management

First, however, every company and every board of directors will have to ask itself whether and to what extent its own risk assessment changes based on the environmental risks that arise through factors such as climate change, for example. The report from the Task Force on Climate-related Financial Disclosures (TCFD), which was commissioned by the Financial Stability Board of the Bank for International Settlements (BIS) in 2017 and met with broad approval, is perfect for just that purpose. This report contains the figure below that shows how such risk and opportunities from climate change translate into financial impact.

Climate-Related Risks, Opportunities, and Financial Impact

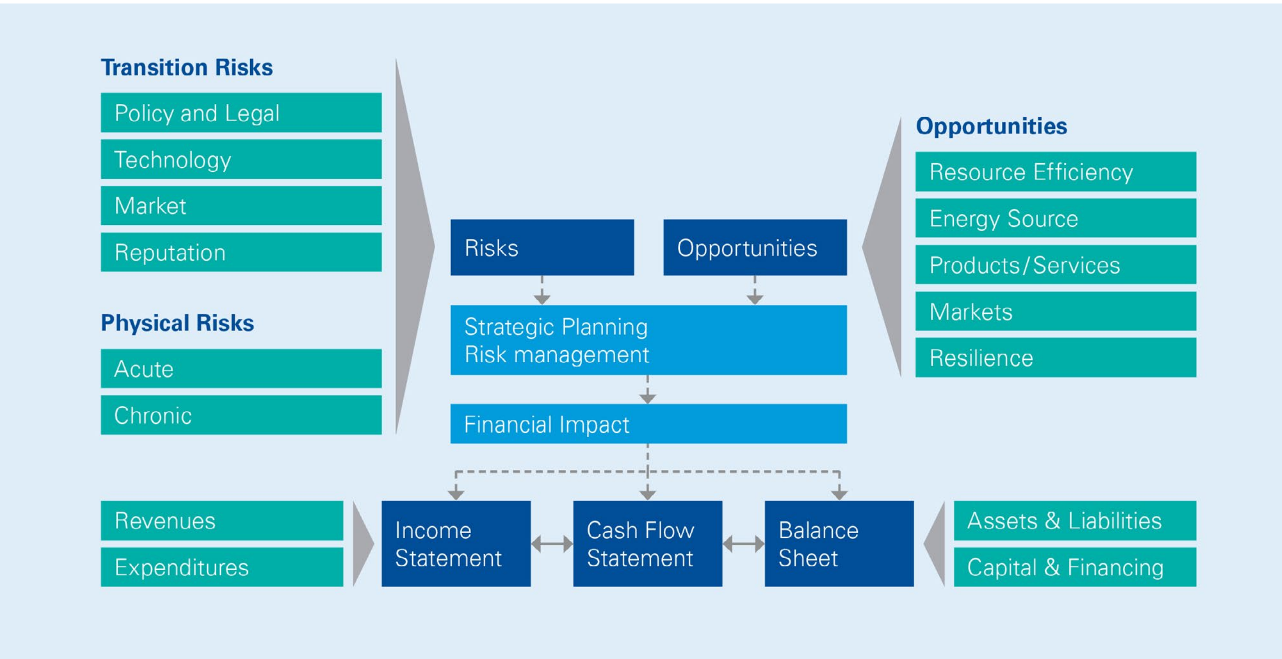

Fig. 2: Recommendations of the Task Force on Climate-related Financial Disclosures, Final Report, p 8, 2017

It goes without saying that factoring in risks, especially those that only manifest themselves in the long term, will have major financial implications. The report mentioned above provides helpful examples for all these risks. But since existing accounting standards are not fully capable of portraying those financial implications adequately – in part because of their retrospective nature – the task force limited its recommendations to mainly focus on disclosures.

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organization's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.	Disclose how the organization identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.
Recommended Disclosures	**Recommended Disclosures**	**Recommended Disclosures**	**Recommended Disclosures**
a) Describe the board's oversight of climate-related risks and opportunities.	a) Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.	a) Describe the organization's processes for identifying and assessing climate-related risks.	a) Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.	b) Describe the organization's processes for managing climate-related risks.	b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
	c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	c) Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

Fig. 3: Recommendations of the Task Force on Climate-related Financial Disclosures, Final Report, p 14, 2017

In the past, companies expanded their non-financial reporting, which then caused the scope of sustainability reporting to swell:

Growth in sustainability reporting

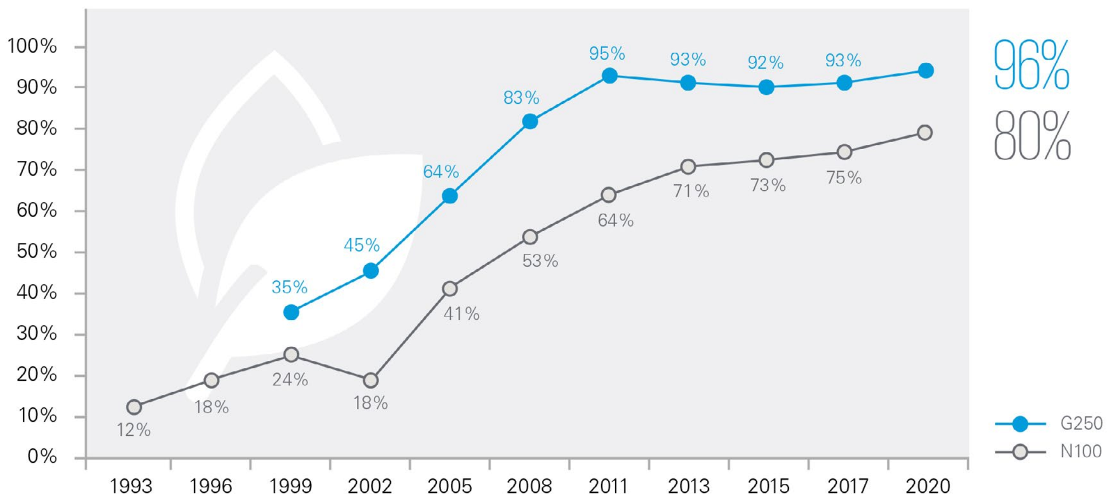

Fig. 4: Growth in sustainability reporting, The Time Has Come: The KPMG Survey of Sustainability Reporting 2020

Large, international companies in particular have been reporting on their efforts on non-financial matters in general for some time now, with some of those reports being extremely comprehensive. Interested recipients of those reports might wonder, though, which underlying standard was used and how comparable they are with those of other companies. Plus the connection between sustainability reporting and financial reporting has remained vague.

Despite the fact that the scientific community already began studying sustainable business management and its connection with compliance, etc. 30 years ago as mentioned above, for many years it was left up to businesses to make a voluntary commitment to the concept. Even without being subject to any legal requirement, they have managed to make a difference and achieve quite a lot. This commitment was insufficient in the eyes of the political community, however. And the European Commission started looking at the financial system in order to shift things in the private sector up to a higher gear. That then prompted financial institutions to start factoring sustainability-related aspects into their investment decision-making processes, which in turn increased demand for companies to provide this type of information.

Recent developments in Europe

After the UN 2030 Agenda was approved, other initiatives including the Paris Climate Agreement, etc. called for state and private funding to favor low GHG (greenhouse gas) development.

Based on that, the European Commission proclaimed its European Green Deal in December 2019 with the goal of making Europe the world's first climate-neutral continent by 2050. A gigantic amount of funding is needed to reach this goal, with some putting the price tag at around 350 billion euros per year for the next ten years. While a sum of this magnitude is beyond the means of public budgets, the European Commission is holding the private sector and banks, in particular, accountable. The latter, for example, are required to make investments in more sustainable technologies and businesses while also labeling financial instruments in terms of their environmental friendliness.

The European Commission published its CSR Directive (2014/95/EU) back in 2014. This directive provided for comprehensive reporting requirements on information related to the non-financial performance of certain large companies from the 2017 financial year onwards. These disclosures were to include information on environmental matters, social matters and treatment of employees, respect for human rights as well as anti-corruption and bribery. Since this reporting was not required to comply with any specific standard and the directive referred to national, European or international frameworks, the information disclosed was not comparable, which limited its usefulness to investors.

As a result and within the framework of its Corporate Sustainability Reporting Directive, the European Commission presented proposals in April of this year that would greatly extend the scope of companies subject to these requirements, introduce mandatory reporting standards and require that the disclosures be audited. These amendments are aimed at eliminating weaknesses in the CSR Directive while also improving the comparability, usefulness and reliability of this information.

At the same time, the European Commission also broadened the mandate of the European Financial Reporting Advisory Group (EFRAG), which had previously been responsible for transposing IFRSs into EU law. The European Corporate Reporting Lab, which forms part of EFRAG, has published its first deliberations on some possible EU non-financial reporting standards in the context of the European Green Deal. The proposals are based on existing frameworks, much like those from the Task Force on Climate-related Financial Disclosures (as mentioned above) or the International Integrated Reporting Council.

They provide for an ESG report (E for environmental, S for social and G for governance) with the following thematic content:

«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

From (European) companies' point of view, the fact that this establishes a uniform framework for sustainability reporting is welcome news. On the other hand, it will create another set of rules that, unlike existing frameworks, probably promises less flexibility – or at least that is what initial proposals from the European Reporting Lab suggest. The repercussions of economic activity, for example, are to be broken down into the three E/S/G categories mentioned and depicted at three levels (sector agnostic, sector specific and entity specific). The existing concept of double materiality represents a key element. It focuses both on how economic activity impacts the environment (impact materiality) as well as the financial impact that environmental issues have on a company's business activities (financial materiality). Both this and the EU's existing Taxonomy regulation will probably be linked to the related disclosure requirements, which could make them one of the most important ESG indicators.

Incidentally, the same trends can be observed at the international level. Both financial and non-financial reporting are increasingly being viewed as two sides of the same coin. It is only logical, therefore, that the International Accounting Standards Board (IASB), which publishes the IFRSs, has announced the creation of an International Sustainability Standards Board that will develop non-financial reporting standards going forward.

Need for action and takeaways for board members

First of all, it should be mentioned that 80 of the 100 largest companies in Switzerland produce a sustainability report on a voluntary basis. Three quarters of those companies refer to the standards set forth in the Global Reporting Initiative (GRI). Even if these reports are welcomed by shareholders, voting rights consultants and analysts, they are frequently criticized for their lack of comparability and content. At the global level and especially in the EU, it has become generally accepted that sustainability reporting standards are needed in addition to the internationally accepted financial reporting standards (IFRSs). Whereas the creation of an International Sustainability Standards Board has only been announced, the European Commission has already taken action and commissioned the European Reporting Lab with the task of elaborating a set of ESG reporting standards. These efforts can be expected to have a direct or indirect impact on companies in Switzerland (as was already the case with the EU's CSR directive in combination with the indirect counterproposal to the Responsible Business Initiative).

In your capacity as a board member, you are well advised to pay careful attention to these developments at both the European and global levels. You should also take steps to ensure that efforts currently being made on a voluntary basis remain in place. You might even want to expand them. They will help companies successfully inform interested members of the public about the sustainable nature of their activities. More active efforts on the part of legislators and supervisory authorities (including FINMA, for example) will raise the requirements of companies' internal processes. Against that background, boards of directors are advised to seize the next opportunity to address questions about suitable reporting processes, the tools required to expand these processes where necessary and related control mechanisms. In doing so, you – in your capacity as a board member – can help your company take advantage of opportunities connected to sustainability reporting and prepare it to face the challenges that recent developments in Europe will bring.

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