Hengeler Mueller

Deutsches Aktieninstitut

Companies & ESG

Transformation
or just reporting?

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1. Introduction

As part of the Green Deal, the European Union has decided to propel the sustainable transformation of its Member States forward and to make Europe the first climate-neutral continent by 2050. The aim of the EU's sustainable finance framework is to channel private investment into transitioning the bloc's economy to a resource-efficient and climate-resilient one.

Where exactly do companies stand in their transformation process(es)? What is motivating them? How do they assess the opportunities and benefits of the legislation on sustainability reporting? A joint survey conducted with the law firm Hengeler Mueller sought to answer these questions – and arrived at some surprising results.

This study consists of two sections. The first part outlines companies' motivations to do business more sustainably and whether and how this has had an impact on the corporate governance and culture within the companies. The study also lists measures taken by companies to promote sustainability on environmental, social and governance topics within their organisations, to establish compliance with reporting requirements and to monitor the status of implementation of processes and measures. The second part of the study focuses on what the respondents think about sustainability reporting requirements.

On the one hand, we received a range of predominantly positive feedback on the potential and expected benefits of the transformation and respective measures. On the other hand, survey respondents view sustainability reporting legislation critically. This study presents and contextualises the responses to our survey. In addition, we analyse and explain the discrepancies between the responses from part one and part two of the survey.

Similar to the survey we conducted two years ago, we did not define sustainability or its key components, environmental, social and governance (ESG). Instead, our survey was based on the respondents' understanding of ESG. In some cases, we were able to draw direct comparisons with our previous study from 2022 on companies' transformation processes. We asked some of the same questions, regarding respondents' motivations for example, to see whether and how their assessments have changed in the last two years.

Interviews with

- Claudia Kruse, Managing Director Global Responsible Investment & Governance, APG Asset Management,
- Dr Michael Müller, CFO, RWE AG,
- Dr Nicolas Peter, Chairman of the Audit Committee, KION GROUP AG, and
- Katharina Tillmanns, Head of Sustainability, Sartorius AG

highlight how the opportunities are seen from the perspective of investors, management boards, supervisory boards and practitioners within the company, as well as offer insight into how companies are progressing in their transformations.

The full study including the interviews in German can be found here:
https://www.dai.de/ESG-Studie-2024.

2. Summary

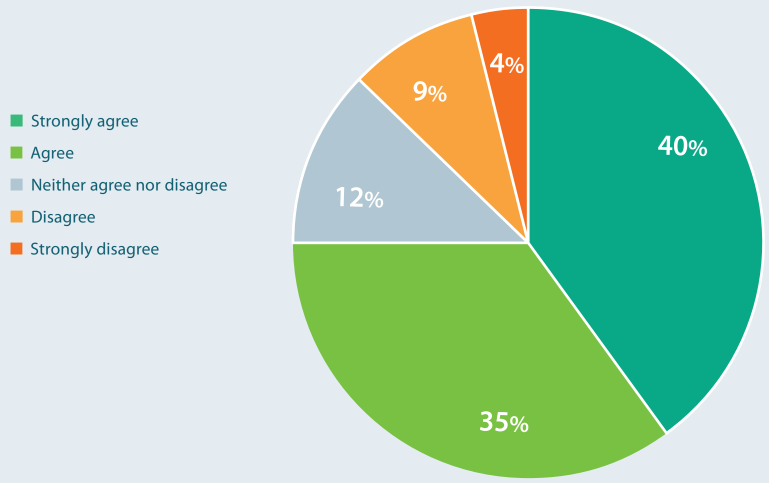
2.1 Drivers, effects and trends in transformation processes

In the first part of the survey, we asked what factors are driving companies to do business more sustainably. Further, we inquired how the transformation process is reflected in companies' corporate governance, what goals companies have set themselves, what impact the sustainability transformation has had and what measures companies are taking to monitor the process.

Opportunities and motivation

Three-quarters of the survey respondents see opportunities for their company in the transformation towards greater sustainability, including potential competitive advantages. In contrast, the survey respondents take a much more critical view of the positive aspects that can result from the mandatory reporting requirements.

Do you see ESG as an opportunity at your company?



n = 114

Figure 1: Is ESG seen as an opportunity

Various factors play a role when it comes to the question of what motivates companies to press ahead with their sustainability transformation. Leading factors are a sense of responsibility, employee motivation and reputational concerns. However, investor and customer expectations were also cited by around two-thirds of the respondents as important or very important motivations for becoming more sustainable. The human factor is therefore key to companies' motivations.

What factors are driving your company to do business more sustainably?

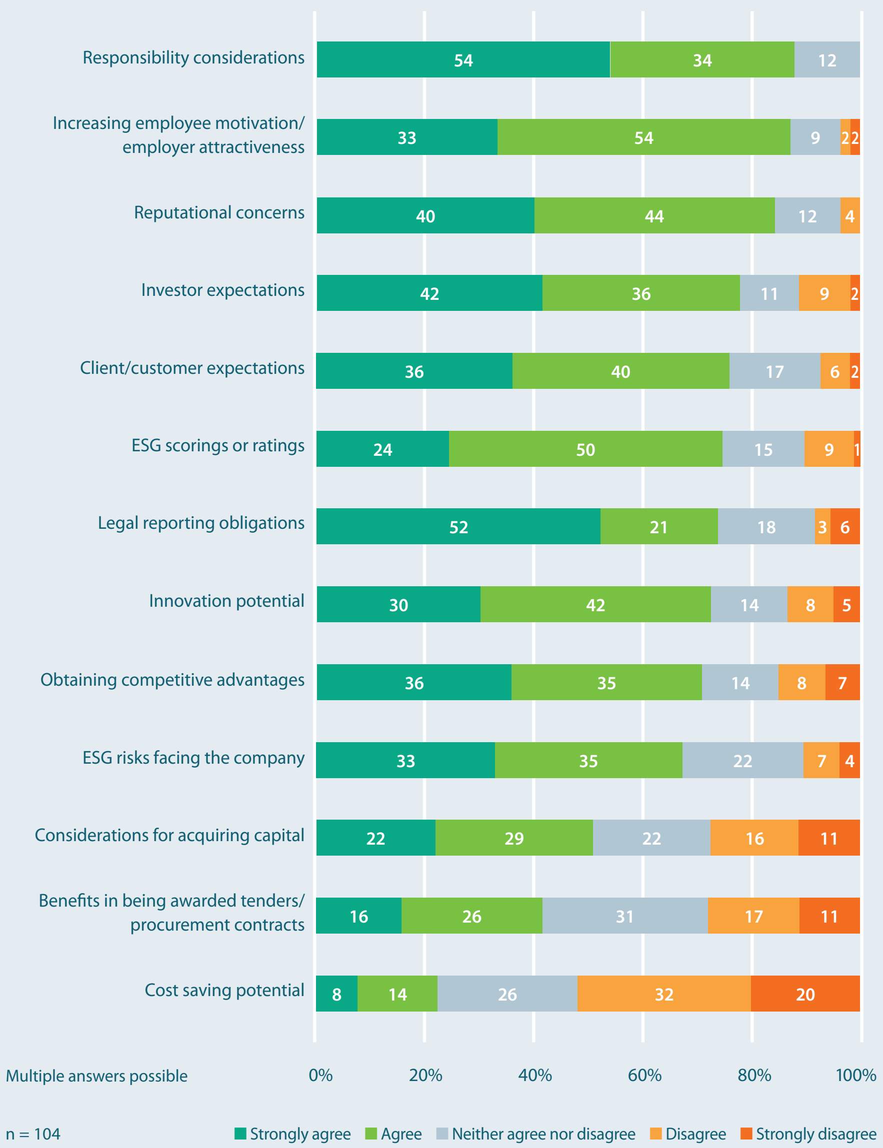


Figure 2: Respondents' motivation to operate more sustainably

Effects on organisation and strategy

We did not want to stop at asking about motivations. That is why, in our survey, we also looked at how companies are implementing their specific efforts for more sustainability. The answers provide insights into numerous implementation measures that are not exclusively the result of regulatory requirements.

Not surprisingly, the increase in the amount of mandatory reporting takes the top spot when it comes to the impact of the transformation process. The extensive requirements mean companies need to have more reporting capacity and better knowledge of reporting practices. The expansion of reporting obligations has also meant that there is more expertise at companies. Compared to the study from 2022, the focus today is more on training for the boards and the expansion of their know-how.

Almost 80 per cent of the survey respondents said they had changed their strategic direction or established a sustainability strategy, three per cent more compared to the previous study in 2022. Sustainability is being treated increasingly as a strategic consideration.

What has changed due to the increased relevance of ESG within your company?

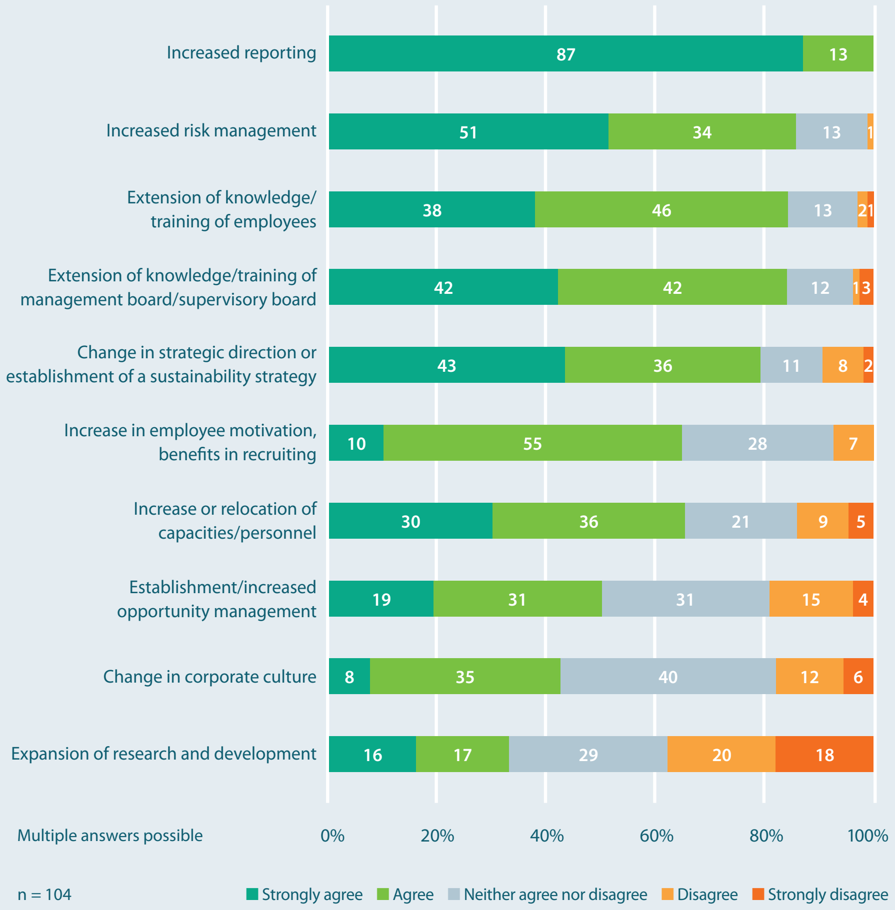


Figure 3: Impact of ESG on the company

ESG KPIs in corporate controlling and management board remuneration

Organisational and procedural measures and corresponding incentives for management are needed to promote and measure self-imposed, usually long-term ESG goals. Strategic goals must be translated into suitable short-term operational milestones, specific key figures must be defined and measurement methods must be established.

We asked what measures companies are taking to support and ensure the implementation of their own ESG goals. There has been a major leap forward in anchoring ESG KPIs (key performance indicators) in corporate controlling. While only half of companies used specific ESG KPIs in 2022, this figure has now risen to more than 80 per cent. This shows that companies want to actively manage their sustainability.

At almost 90 per cent, integrating ESG KPIs into management board remuneration by the supervisory board is the tool that most companies already use according to respondents. The management board can revert to most of the processes and measures surveyed, such as internal or external audits. Management board remuneration, on the other hand, is a tool that the supervisory board can use to ensure that sustainability goals are implemented. Compared to the 2022 study, in which only 65 per cent used ESG targets in remuneration, a significant increase can also be seen here.

What measures does your company take to support and achieve the implementation of ESG targets?

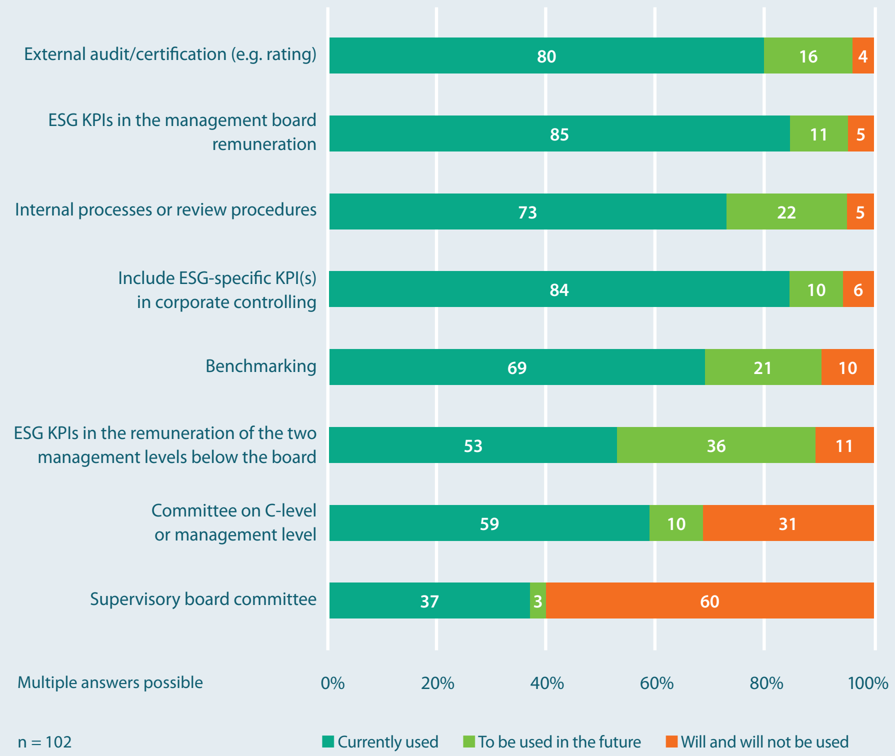


Figure 4: Measures to promote and ensure the implementation of ESG objectives

ESG targets are more likely to be found stipulated in management boards' long-term variable remuneration schemes, i.e. the long term incentive (LTI), with 72 per cent of respondents saying so, rather than as part of short-term variable remuneration plans, the short term incentive (STI, 57 per cent). Sustainability transformation goals are intended to promote long-term thinking and planning within companies. ESG targets therefore are usually designed for the long term. Nevertheless, it may be appropriate to break these down into short-term targets.

Figure 5: ESG targets in Executive Board remuneration – LTI, STI and transition plans

Transition plans also play a role in the definition and measurement of ESG KPIs. Such plans contain the key targets, individual milestones or key figures that outline a company's path to climate neutrality. In some cases, the company's supervisory board also uses these key figures in designing the system for the management board's remuneration, as our study shows. Transition plans thus contribute to the achievement of self-imposed targets. They also contain data and figures that investors and banks can use in making their investment decisions as, unlike reporting, they describe in concrete terms companies' plans for the future. In view of the various regulations that are currently being developed worldwide, we believe it would be important to achieve a coordinated international approach to avoid a multitude of possibly contradictory guidelines on transition plans.

We also asked respondents which „E, S and G" KPIs specifically are found in management board remuneration. The topics of climate (E), the company's own workforce (S) and women in management positions (G) were cited the most. One reason for this could be that these are topics that are currently of great importance for many companies, both politically and socially.

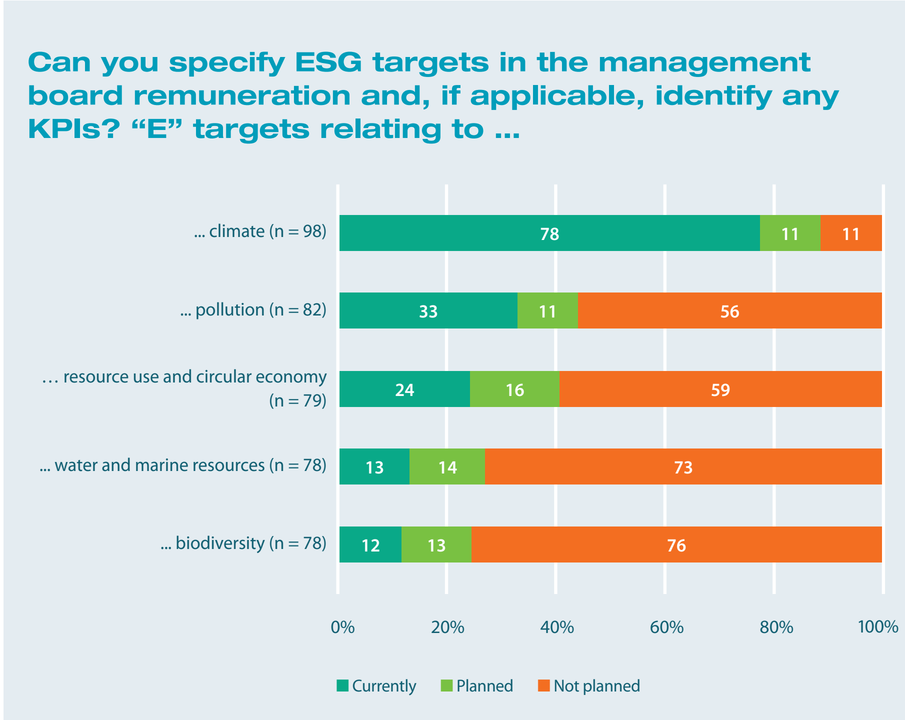


Figure 6: Targets from the "E" are in the remuneration of the Executive Board

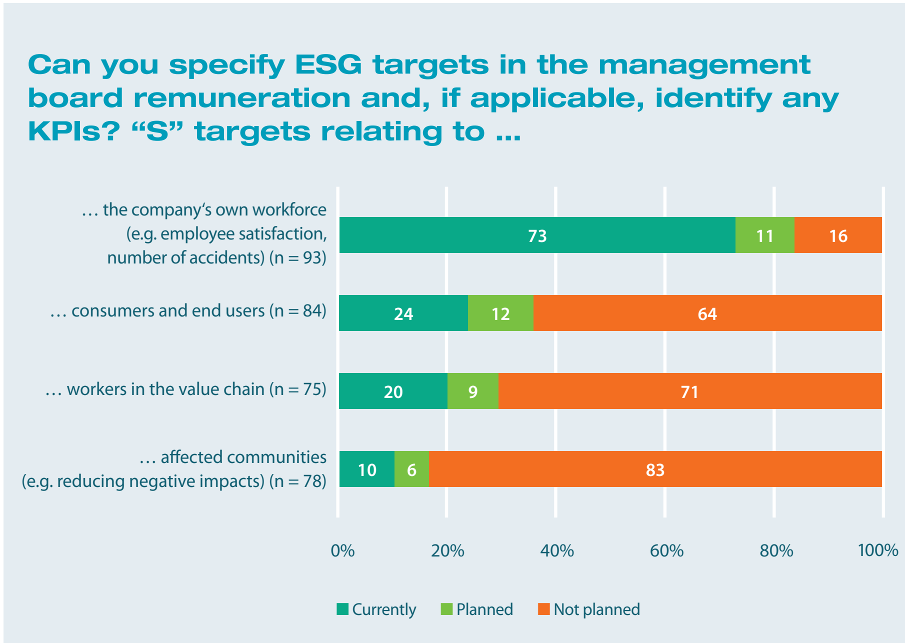


Figure 7: Targets from the "S" area in the remuneration of Executive Board

Can you specify ESG targets in the management board remuneration and, if applicable, identify any KPIs? "G" targets relating to …

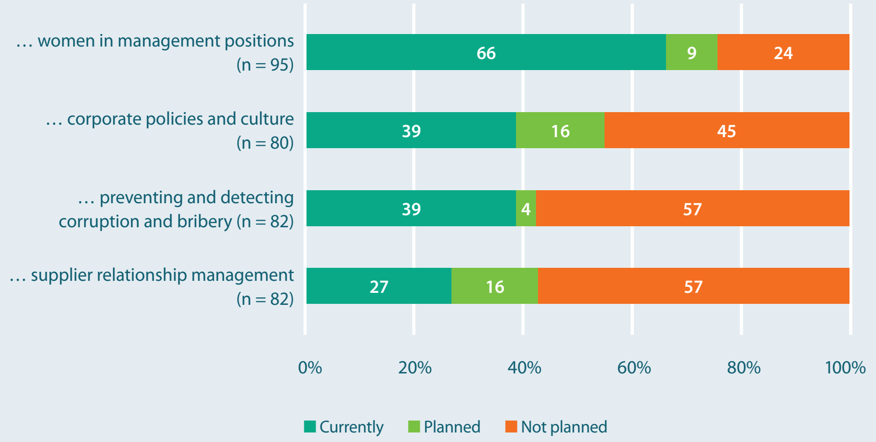


Figure 8: Targets from the "G" area in the remuneration of the Executive Board

2.2 Sustainability reporting in accordance with the CSRD and the EU Taxonomy Regulation

In the second part of the study, we focused on the Corporate Sustainability Reporting Directive (CSRD), the European Sustainability Reporting Standards (ESRS) and the EU Taxonomy Regulation. These pieces of legislation play a major role in Europe achieving its transformation goals.

The CSRD's and the ESRS' reporting obligations are designed to provide investors and other relevant stakeholders with key information on companies' sustainability efforts. Lawmakers also contend that the collection of the data also gives companies the opportunity to get a clearer picture about their future viability. Furthermore, the information is seen as being the prerequisite for enabling users to compare competitors and to benchmark.

EU taxonomy defines which economic activities are considered sustainable. Companies are obliged to report on the conformity of their economic activities with those definitions. Investors can use this information to invest in sustainable economic activities – at least that is the idea.

2.2.1 CSRD und ESRS

All respondents confirm that they have started to implement the European Sustainability Reporting Standards. More than 50 per cent state they are already at an advanced stage. Three per cent of respondents even say they have already completed the implementation of the ESRS.

How do you assess the benefits in relation to the efforts regarding the following requirements under the Corporate Sustainability Reporting Directive?

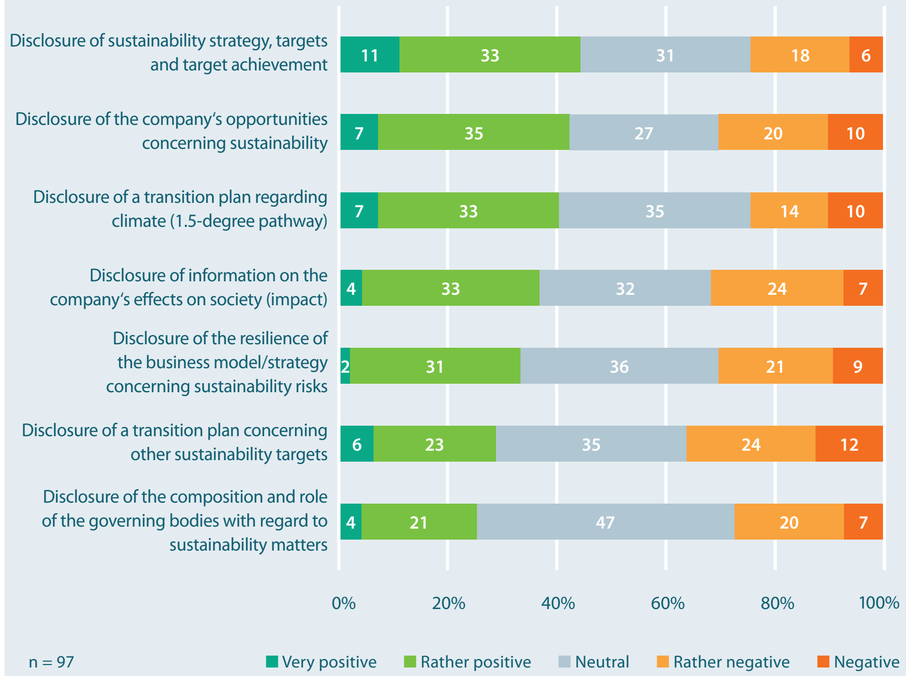


Figure 9: Benefits in relation to the cost of CSRD requirements

None of the CSRD requirements that we asked about had an approval rating (total value of strongly agree and agree) of 50 per cent when it came to the relationship between the costs and the benefits.

The disclosure of a sustainability strategy and of the opportunity management regarding sustainability as well as the disclosure of transition plans achieved the highest values with over 40 per cent. In the previous study, we asked respondents to assess the costs and benefits of a reporting requirement on companies' opportunities in the area of sustainability. At that time, 61 per cent of respondents had a positive view of the cost-benefit ratio of such a reporting requirement. However, the positive assessment of the reporting requirement has now dropped significantly to 42 per cent. One reason for this relatively low approval could be that companies have so far focussed on risk management. Companies have not yet addressed opportunity management to the same extent.

The cost-benefit ratio for the disclosure of climate transition plans is viewed as a positive by 40 per cent of respondents. This is encouraging, as climate transition plans are becoming increasingly relevant. They are being used more and more by investors as a basis for their investment decisions.

Critical assessment of the opportunities arising from reporting

Respondents were also asked what positive aspects they see in the sustainability reporting requirements. The comparability of ESG data tops the list at the positive end of the scale. However, 54 per cent is relatively low since comparability is a key objective of the ESRS.

What are the opportunities arising from ESG reporting requirements at your company? How do you assess them?

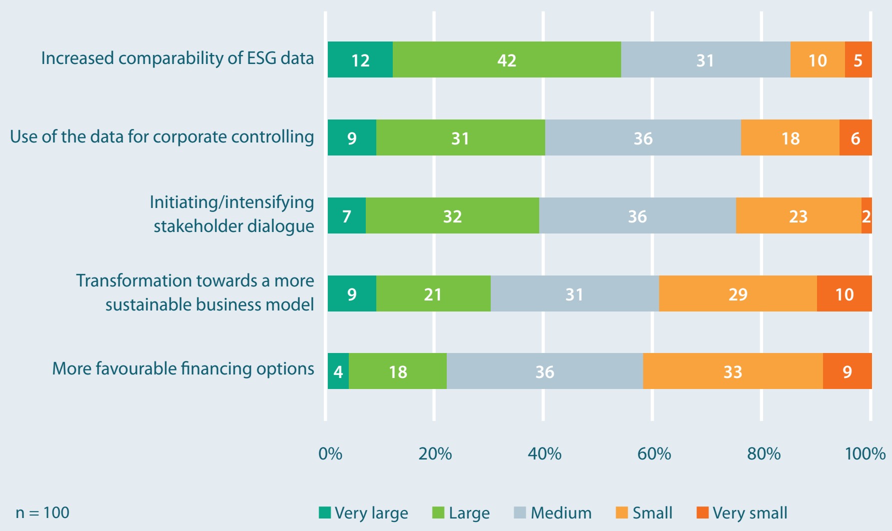


Figure 10: Opportunities for sustainability reporting

In our opinion, the reasons for this could be the challenges in collecting the data and the high number of unclear legal terms used in the standards. Collecting data along the value chain is time-consuming, and if data cannot be obtained, estimates can be used. This is detrimental to the comparability of the data. The fact that the standards require interpretation can lead to very different results among companies, meaning in the end this will not be an apples-to-apples comparison.

The two lowest rated opportunities associated with the reporting obligations are the transformation to a more sustainable business model, which was given a positive rating by 30 per cent of respondents, and the better financing they can lead to, which was seen positively by only 22 per cent of respondents.

Respondents' views on the opportunities associated with transforming their companies to become more sustainable and the opportunities resulting from sustainability reporting requirements clearly diverge. Why do companies not expect better sustainability reporting to result in easier access to financing or greater benefits for corporate controlling? We believe that, from the respondents' perspective, the current approach to reporting misses the target of channelling capital flows into the sustainable transformation of business. In view of the enormous resources that reporting ties up, there is need for improvement.

Granularity of reporting requirements and data collection are the biggest challenges

Over 90 per cent of respondents see the granularity of reporting and data collection as a major challenge. Overall, reporting is viewed more negatively than in the previous study. This may be related to the fact that companies are at an advanced stage in implementing the ESRS. In 2022, the requirements as they were in the draft of the CSRD may have still sounded reasonable. With the concretisation of the standards, disillusionment may have set in. As the respondents' answers would suggest, this could be due to the granularity of the reporting requirements, the difficulties in data collection and the complexity of the requirements and the amount of resources needed to ensure compliance with them.

What are the challenges concerning the ESRS implementation?

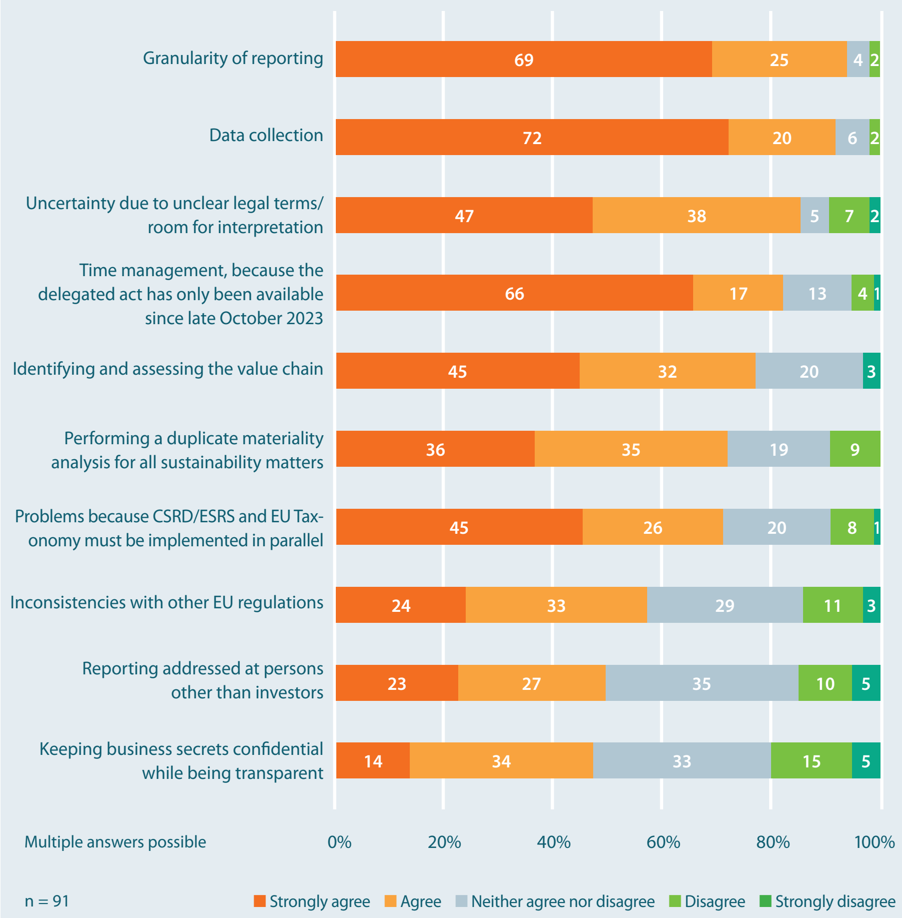


Figure 11: Challenges in implementing the ESRS

2.2.2 The EU Taxonomy Regulation

The costs and benefits of the reporting are disproportionate

Alongside CSRD reporting, the EU Taxonomy Regulation is the second important building block in the European sustainability legislation. In the 2022 study, a third of survey respondents were already critical of the cost-benefit ratio of disclosures on green revenue, capital expenditure (CapEx) and operating expenditure (OpEx). Two years later, the negative responses are even twice as high.

How do you assess the benefits regarding the reporting obligations under the EU's Taxonomy Regulation in relation to the efforts?

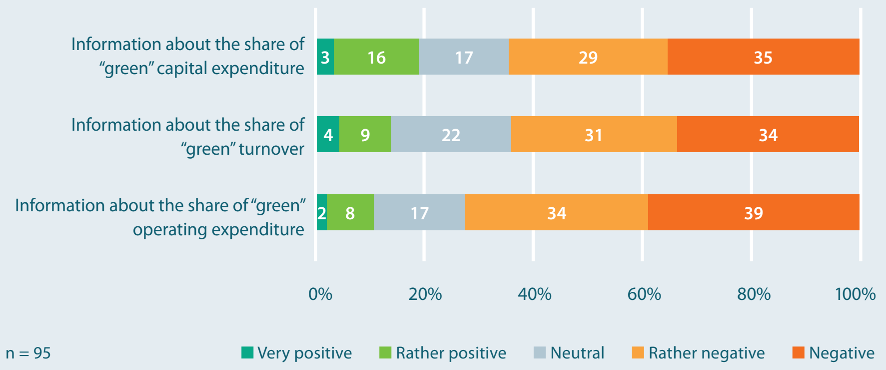


Figure 12: Assessment of the costs versus benefits of the EU Taxonomy Regulation

Challenges during implementation

The limited benefits of EU taxonomy for banks and investors top the list of challenges, with 84 per cent of respondents saying so. This assessment is worrying. The benefits for banks and investors are therefore no longer an element that legitimises the high implementation costs.

Since the EU Taxonomy Regulation has not been in effect for very long, no best practice has yet emerged. Eighty per cent of respondents are lacking a best practice in the auditing process.

As in the previous survey, we wanted to know whether companies are able to make investment decisions based on the EU Taxonomy Regulation. Three-quarters of respondents currently believe that the taxonomy is (rather) unsuitable for corporate investment decisions. This is a significant change compared to 2022, when only 41 per cent felt this way. One reason for this development could be that companies have had negative experiences with the usability of the data. In principle, the usability of the data is also limited by the fact that the technical screening criteria for the taxonomy requirements are to be evaluated every three years, meaning that long-term investment decisions are difficult to make.

What are the challenges during the implementation of the EU Taxonomy?

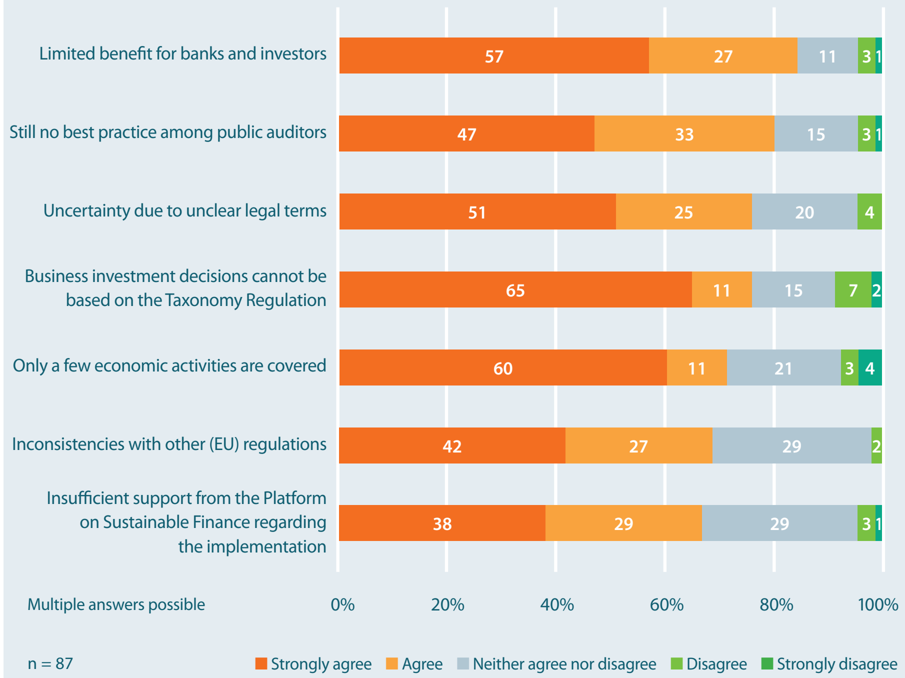


Figure 13: Challenges in implementing the EU taxonomy

3. Recommendations

The survey results show that companies consider sustainability issues to be essential for their business and are managing them more and more actively. However, they also give the impression that legislation does not sufficiently support companies in their transformation efforts. In addition, the level of detail and overlaps in (mandatory) reporting tie up companies' resources and therefore hinder rather than promote their activities. In order to change this negative situation, the following legal changes and initiatives may prove to be advantageous:

- The significant streamlining of the ESRS done as part of the initiative to remove 25 per cent of companies' reporting obligations, presented by EU Commission President Ursula von der Leyen last year.
- A practical-orientated revision of the taxonomy reporting framework by the next EU Commission in close cooperation with companies.
- The EU Commission's commitment to an international guideline for transition plans that avoids global fragmentation in this area.

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