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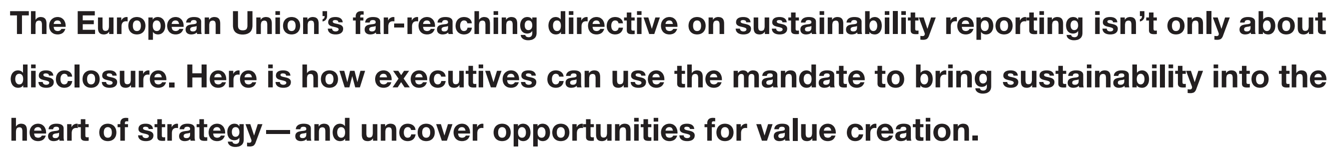


The European Union's far-reaching directive on sustainability reporting isn't only about disclosure. Here is how executives can use the mandate to bring sustainability into the heart of strategy—and uncover opportunities for value creation.

by Eu-Lin Fang, Peter Gassmann, Kevin O'Connell and Nadja Picard

How will your company create value in a world focused on sustainability? Put that question to a roomful of CEOs, and you'll likely hear a wide variety of answers, touching on net-zero targets and decarbonisation pathways, on efforts to design green products and services, on circular-economy projects. Only a few CEOs would mention making bold strategic moves to align their business's portfolio, offerings and capabilities with the opportunities that the sustainability agenda will create. Or would consider carrying out forceful strategic pivots to avoid the serious risks that stem from environmental and social ills such as climate change and economic inequality.

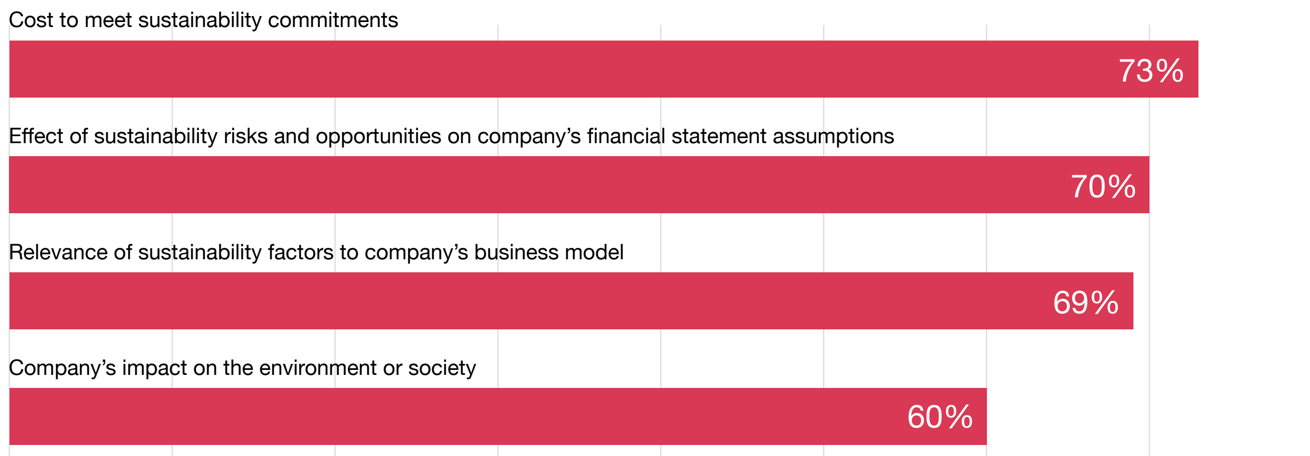
Soon, though, many more CEOs may decide to address the strategic and financial implications of sustainability, in part because of new reporting standards set by the European Union, the US Securities and Exchange Commission, and the International Sustainability Standards Board. Of these "big three" mandates, one stands out: the EU's Corporate Sustainability Reporting Directive (CSRD). Published in December 2022, the directive applies to some 50,000 businesses that are listed in the EU or have significant operations there, regardless of where they're based. And it requires them to report more about their sustainability performance than any other piece of regulation to date, beginning with the 2024 fiscal year in some cases.

While the *letter* of the CSRD calls for extensive reporting, the *intent* of the CSRD is to drive change in business conduct. The directive obliges executives to analyse sustainability issues such as climate change, biodiversity loss and human rights; relate them to the company's financial opportunities and risks as well as its impacts on society and the environment; and disclose strategies and plans for managing sustainability performance and financial performance in tandem.

The sharing of all this information, we believe, will have transformative effects. More executives should expect to be assessed and compensated according to their company's sustainability performance. Pronounced effects could also play out in the capital markets. Solid majorities of investors agreed in a recent PwC survey that it's important for companies to report such information as the influence of sustainability risks and opportunities on accounting assumptions. CSRD reports will equip investors with more consistent, more comparable data. We expect many will use this data to value companies, rewarding those that articulate a compelling narrative about how they will compete amid sustainability-driven market forces (see chart).

Most investors agree that it's important for companies to report information on the relevance of sustainability factors to their business, and on their sustainability-related activities

Share of respondents saying that for their investment analysis and decision-making, it is 'important' or 'very important' for companies to report:



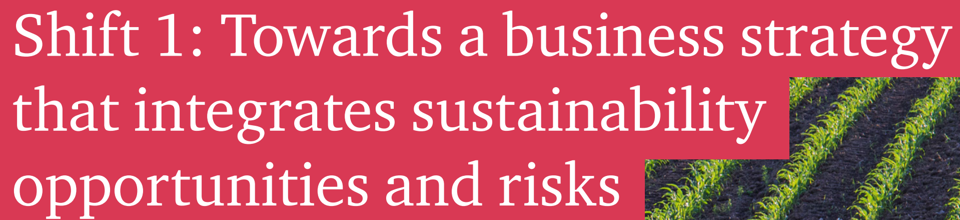
Source: PwC's Global Investor Survey 2022

Of course, if executives choose to approach CSRD reporting as a mere exercise in box-ticking—if they opt not to consider the links between sustainability and value creation—then they'll probably see fewer gains. Worse yet, they could find that their company's value erodes, as investors recognise that its reported strategy fails to account for sustainability-related risks and opportunities. On the other hand, executives who properly apply the logic of the CSRD can better understand how sustainability factors affect value creation, and thereby lead towards stronger financial results. As we explain in this article, this approach calls for the entire top team to make four shifts in the way they manage: to integrate sustainability in strategy, to recognise companies' impact on the world, to improve decision-making and to produce more useful data.

CSRD at a glance

What is the CSRD?	The CSRD, the EU's Corporate Sustainability Reporting Directive, is a new piece of regulation. It requires companies to make extensive, detailed disclosures about sustainability performance and related strategic implications. Disclosures are prescribed by the European Sustainability Reporting Standards (ESRS).
Which firms are affected?	About 50,000 companies globally, including those in the following categories: ▪ Companies with securities listed on an EU-regulated market (with some exceptions, such as 'micro-undertakings'). ▪ Unlisted EU companies of a certain size (including EU subsidiaries of companies headquartered outside the EU, which may be covered by the parent companies' consolidated reporting). ▪ Unlisted EU parent companies with total holdings of a certain size.[1]
What's required?	Companies must assess the materiality of sustainability topics across their value chains and then consider which of more than 1,000 data points to disclose. Other disclosures will consist of qualitative information, such as how the corporate strategy accounts for sustainability opportunities and risks. All the information requires independent assurance (beginning at the limited level).
Who's responsible?	The CEO, the CFO, the CSO, the CIO—indeed, the whole management team—will have new day-to-day tasks. The supervisory board and audit committee must oversee a company's sustainability reporting.
When must businesses comply?	Companies that are now subject to the EU's Non-Financial Reporting Directive will have to follow the CSRD for fiscal years starting on or after January 1, 2024 (filing reports in FY2025). Other listed companies, along with unlisted companies meeting certain size thresholds,[1] will get more time.

[1] Companies must comply with the CSRD if they exceed two of the following three size thresholds: total assets of €20 million, revenue of €40 million and an average of 250 employees during the fiscal year on two consecutive balance-sheet dates.



Shift 1: Towards a business strategy that integrates sustainability opportunities and risks

The most significant shift resulting from the CSRD, we believe, will be a shift in the way that executives relate their business strategy to the sustainability agenda.

Though some executives do integrate sustainability topics with their core strategies, the practice has not yet gone mainstream. Management can still base their strategy on more traditional concerns—customer needs, competitive dynamics, economic trends, technology advances and so forth—while handling sustainability topics such as climate change and human rights as matters calling only for legal and regulatory compliance. As a result, one company's effort to link sustainability with value creation can differ greatly from another's.

The CSRD should change this, by increasing transparency. Under the directive, executives must show how they have assessed business opportunities and risks related to sustainability matters (including companies' impacts on the environment and society), as well as the possible effects on financial outcomes. They must explain whether and how their overall strategy addresses sustainability factors and their financial implications, and how they plan to improve sustainability performance. And they must document all this in a single report—which investors and other stakeholders will use for benchmarking. Faced with additional scrutiny, executives will benefit from explicitly aligning business strategies, plans and processes with sustainability considerations.

Furthermore, the CSRD requires management to report how their strategy and plans deal with each sustainability topic that they consider material (according to an expanded definition of materiality, which we explain below). For example, if executives at an apparel

company identify water use as material, then they would have to tie their strategy and goals to pertinent impacts, opportunities and risks. They would also need to disclose related performance indicators, such as water use across the value chain—from cotton growing to textile processing—and water consumption in water-stressed areas. Unless executives take care in assessing sustainability topics and planning responses, their disclosures could lead stakeholders to conclude that the company faces unwelcome financial consequences.

Integrating sustainability knowledge with high-level strategic planning requires a cross-functional approach, overseen closely by the CEO in consultation with the board.

Another example: if a company operates in a sector, such as coal mining, where demand will likely shrink due to sustainability pressures, executives will need to report this—including potential revenue losses under different scenarios. They will also need to lay out the company's so-called transition plan, describing how it will manage these market shifts. (Some electric utilities, for instance, have pivoted away from carbon-intensive assets and towards assets that serve the growing market for renewable, low-carbon energy.) Or, if climate change will make mining sites and offices more prone to flooding, leaders will need to present plans and investment schedules showing how the company will develop resilience.

In our experience, management teams at leading companies integrate sustainability knowledge with high-level strategic planning by taking a cross-functional approach, overseen closely by the CEO in consultation with the board. Some choose to form multidisciplinary teams of specialists in finance, sustainability, investor relations and strategy, and have them recommend comprehensive ways to address challenges and opportunities resulting from sustainability matters. For example, companies often stand to gain from factoring green taxes and incentives—which number in the thousands—into their strategies. Experience also suggests that CFOs are especially well placed to contribute, by directing the use of sustainability factors in strategic and financial planning and holding productive conversations with investors.

Shift 2: Towards greater attention to your business's impact on the world

When it comes to setting strategy, the CSRD specifies another important activity: it requires executives to understand and manage any significant impacts that their company has on the environment and society.

As it is, leaders often consider sustainability topics in terms of how those topics could affect the company's finances—an "outside-in" view of materiality. Physical climate hazards such as floods and wildfires, for example, can damage property and disrupt operations. The CSRD obliges executives to take an "inside-out" perspective, too, by looking at their company's environmental and social impacts and managing the most significant ones. This two-way perspective on what topics matter is known as "double materiality"—and adopting it will involve an evolution in management practice.

Many investors do want the inside-out view: in our survey, 60% agree that it is important for companies to report their impact on the environment and society. Leading executives already manage certain external impacts, whether to fulfil their company's purpose or to safeguard their company's licence to operate—witness the 5,000 or so businesses that have committed to set science-based targets for reducing their carbon emissions.

Still, formally judging which external impacts are material is an emerging practice, and few standards exist to guide managers. (The Global Reporting Initiative, a long-standing body that sets voluntary standards for sustainability reporting, refocused its impact standards on materiality in 2021.) The typical approach involves assessing the relevance of impacts based on feedback from stakeholders, such as investors and employees and customers, and input from management.

The CSRD can help executives prioritise external impacts, for it prescribes clearer methods of assessing materiality from the inside out. The directive also charges executives with considering more external impacts than usual—for example, the effects of producing and using microplastics. In the CSRD's social category alone, three of the four topics include external impacts.

To perform its first impact materiality assessment, one consumer-goods company took a list of common sustainability matters for its sector, mapped those topics onto its value chain using a tool developed for this purpose and drew out the cascading impacts that its activities could have. Managers then scored each impact on multiple scales: positive to negative, actual to potential (over several time frames), localised to widespread, minor to major, and remediable to permanent. Knowing the high-materiality impacts, executives devised plans to manage and report on them (see chart).

This illustrative impact assessment describes how a company's water use can affect society and the environment in multiple ways

Low materiality → High materiality

Activity	Outcome	Environmental or social impact	Classification of impact		Scale	Scope	Irremediable character	Likelihood
Water is used during production process	About 200,000 cubic meters of fresh water is sourced per day from the local water utility	Water scarcity in neighbouring communities	Negative	Actual	Local impact	Limited impact with some costs	May be difficult to remedy impact	–
		Revenue to local utility	Positive	Actual	Local impact	Minimum impact with negligible costs	N/A	–
		Dries up downstream channels	Negative	Potential (long term)	Medium-scale impact	Medium-scale impact with some costs	Very difficult to remedy	May not happen
		Habitat loss for native species	Negative	Potential (medium term)	Medium-scale impact	Limited impact with some costs	Non-remediable	May not happen

Source: PwC analysis

Shift 3: Towards decision-making processes that account for crucial performance drivers

Once executives have refreshed their corporate strategies with sustainability factors in mind—including both outside-in and inside-out impacts—they will naturally want to embed any new priorities in their processes for making decisions about capital investments, portfolio design, market positioning and other strategic matters.

The discipline of making business decisions based on non-financial priorities is not new. Many executives across industries focus on performance indicators that aren't measured in monetary terms—such as employee retention or customer conversion—because they know that better performance on those counts can lead to better financial outcomes.

The CSRD reinforces this discipline for sustainability. It requires management to explain whether and how their companies manage sustainability performance, and why they took particular actions. To do so, executives will need credible methods for allocating resources among projects, investments or business units that present different combinations of financial and sustainability attributes. However, these attributes tend to be measured on their own terms—and sustainability factors may not be directly related to financial objectives such as revenue growth.

To take a simplified example, managers at a company might need to choose between investing in a project with strong financial returns (measured in cash flows) and healthy social benefits (measured in job creation and skills development) but less than stellar environmental performance (measured in carbon emissions and waste), and a project with modest financial returns but exceptional social benefits and superior environmental performance. How might managers weigh these factors and select a project?

Our experience suggests that executives can help structure such decisions using frameworks to compare financial and sustainability characteristics in similar terms. For example, BASF, a chemicals company based in Germany, has devised a method (with PwC Germany and PwC UK) to quantify, in monetary units, the economic, environmental and social impacts of a given project across the value chain. By translating these impacts into economic terms, the method helps executives understand the different ways in which a project creates value for society, without their having to interpret a variety of disparate, non-monetary metrics. The method also allows executives to consider the value of each economic, environmental and social impact separately, which facilitates more informed and responsible decisions than would a single, overarching measurement of value.

Shift 4: Towards sustainability data that is as reliable and credible as financial data

To make business decisions that account for sustainability factors, executives and boards must have detailed sustainability data at their fingertips—and they must be able to trust it as much as financial data. But there's plenty of scepticism. In PwC's investor survey, 87% say they believe corporate reports contain greenwashing.

There is reason to think that sustainability data and reports will get better. Even prior to the CSRD, more and more countries had been establishing or expanding requirements for sustainability reporting, including requirements for external assurance. The CSRD raises the bar. Companies subject to the directive must have their sustainability disclosures assured by an outside party, first at the limited level and eventually at the reasonable level, the same level required for financial reports. The resulting improvement in credibility should help executives, boards, and investors engage in more meaningful discussions and reach more confident decisions.

Many CFOs will need to bring systems and controls for sustainability data up to the same standard as for financial data, along with governance and risk management processes.

As any public company CFO can tell you, it takes high-grade systems and controls to collect and manage financial data that can be assured. It takes systems that are even more capable to generate financial data at the high frequency and the fine level of granularity that decision-makers want. Yet we've seen few companies using systems with these qualities for sustainability data. Many CFOs will therefore need to bring systems and controls for sustainability data up to the same standard as for financial data, along with governance and risk management processes.

The task is all the more formidable because it requires identifying and sourcing all the individual pieces of sustainability data, or data elements, needed to calculate the data points that the CSRD calls for. Each data point might comprise up to 20 data elements. If any data elements—which can number in the thousands—are unavailable, then managers must establish processes for gathering them.

That is a lot to accomplish. And it has to be done quickly for organisations that must meet the CSRD's requirements beginning with the 2024 fiscal year. But some, such as one pharmaceutical company based in Europe, are getting it done. The company carefully scoped its efforts to focus on data for management and reporting in the short term and for strategic decision-making in the medium term and beyond. To meet urgent needs, it is using proven elements of its existing tech systems to obtain as much sustainability data as possible, and adding targeted solutions to fill data gaps. And to prepare for the future, the company is integrating sustainability requirements with a major ERP transformation project, which also lessens complexity and cost, an approach consistent with embedding sustainability across management activities.

Leading the shifts: Next steps for executives

By requiring companies to be more transparent, the CSRD will encourage executives to develop—and follow—business strategies that maximise the value they create by managing sustainability factors. Many will want to do so, given that the CSRD's scope covers thousands of businesses based in Europe as well as in Asia, the Americas and elsewhere. And this work can't be assigned to a single executive within a company. As with any other strategic task, everyone in the C-suite must do their part. What roles should they play? Below, we've laid out responsibilities for leaders in pivotal positions.

CEOs

- Lead the effort to understand how sustainability-related impacts, opportunities and risks could affect a company's ability to create value in the short term and the long term, and bring these factors into the core strategy.
- Clarify how performance and impacts for material sustainability topics pertain to business objectives, and establish plans and targets accordingly.
- Assign responsibility to members of the C-suite for instituting systems, frameworks and incentives that promote effective implementation of sustainability priorities and reporting.
- Ensure that executives and managers use consistent parameters and principles for making decisions based on a mix of financial and non-financial information.

CFOs

- Identify gaps in the company's information (or weaknesses in the underlying systems and controls) that could inhibit decision-making and reporting, and set out plans to make improvements or upgrades.
- Work with the CIO on implementing systems and controls to collect and report sustainability-related data that can be independently assured.
- Establish processes and parameters for integrating sustainability factors into business decisions (for example, looking at green taxes and incentives, or creating a social value "budget" that each unit must contribute to).
- Create synergies between CSRD readiness work and other transformation efforts taking place in the finance function, such as system transformation or legal-entity restructuring.
- Lead discussions with investors about how the company's strategy and investments mesh with its sustainability priorities—and how they are helping create enterprise value.

CSOs

- Lead analysis of which sustainability performance indicators, including external impacts, matter most.
- Provide the CEO and CFO with technical expertise in understanding how sustainability topics create business opportunities and risks, and in setting plans and targets to improve performance in material areas.
- Create and execute a plan to ensure that the direction of the business is aligned with the sustainability targets noted in management's external reports.

CIOs

- Work with the CFO on selecting and implementing technology systems to support data collection and reporting.
- Refresh the company's data strategy and data-governance mechanisms to cover sustainability-related information.

Audit committee

- Assume direct oversight of sustainability reporting—similar to oversight of financial reporting—by learning the disclosure requirements, understanding the risks, querying management decisions and engaging with assurance providers.
- Support an overall business strategy that gives management the time and resources to meet its obligations.
- Lead initiatives to prepare for disclosing newly required information, such as targets specified by climate transition plans, and data from the value chain.

The CSRD asks executives to view sustainability topics through a strategic lens and to manage them accordingly. By making these shifts in perspective and practice, leaders will also position their companies to create more value.

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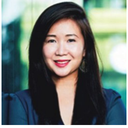

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