International Association of Controllers

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Dear readers

We have chosen this year's thematic focal point – "sustainability controlling" – in order to address current trends and provide associated ideas for concrete implementation challenges. This includes in particular the management of sustainability issues. We illuminate the broad topic of sustainability from the CFO's standpoint, with the aim of actively supporting the transition towards integrated sustainability controlling.

In this newsletter we would like to cover the topic from different perspectives.

The first article presents the impact which CFOs and controllers have on the global climate crisis. It uses a case study from DATEV eG to specify how climate risks can be managed. The second article outlines the regulatory developments that manifested themselves in the field of corporate reporting in November 2022 and places them in the general context of sustainability controlling. The last article covers a lightning interview which the Think Tank conducted with Khai Tran, Managing Director and Co-Founder of Valsight. Mr. Tran provides insights into the CFO's perspective, particularly in regard to the upcoming task of designing viable sustainability management.

We would like to thank the experts from the Think Tank who supported us in creating this 36th edition of our quarterly newsletter (Simon Hein, Dr. Josef Baumüller, Khai Tran and Dr. Kim Dillenberger). We wish you interesting reading and hope you will enjoy this issue.

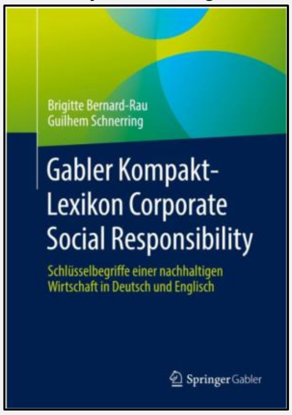
Prof. Dr. Heimo Losbichler
Chairman of the ICV Board of Managing Directors

Prof. Dr. Ronald Gleich
Head of the Think Tank in the ICV

Stefan Tobias
Head of the Think Tank in the ICV

Reading tip

"Gabler Kompakt-Lexikon Corporate Social Responsibility" (translation: Gabler Compact Lexicon Corporate Social Responsibility), a recently published reference book by Dr. Brigitte Bernard-Rau and Guilhem Schnerring, contains around 300 key terms that are relevant to environmental, social and corporate governance issues.



This book helps readers to develop a basic understanding of the current and future implementation of CSR practices, strategies and reporting standards.

The book "Nachhaltigkeit als Unternehmensstrategie" (translation: Sustainability as a Corporate Strategy) by Bernd Hinrichs addresses the key challenge facing companies that aim to implement fully integrated sustainability management. It therefore sets a new standard for sustainable management and shows how ecological responsibility can be lived in a company. To that end Hinrichs provides mapping options, strategies for action, aids to assist the thought process, background information and case studies.

Managing climate risks effectively | How CFOs and controllers impact the global climate crisis

Companies can no longer look away and should deal with environmental and climate risks at an early stage. This includes anticipating possible climate developments and trajectories, assessing their impact on their company's operations and taking them into account in corporate decisions. It is also important to find the right measures to mitigate climate risks. The goal is to ensure the successful and sustainable status of the company as a going concern through early and well-founded information. In that way the resulting opportunities can be exploited over the long term.

Practice shows that companies and their controllers struggle with the topic of sustainability and have so far addressed it only insufficiently. After all, they argue, other departments in the company are responsible for that. But is it not true that controllers are the employees who deal professionally with actual/target comparisons, data analysis and well-founded interpretation of the results, and impact assessments?! Climate change and its consequences are often ignored, particularly because the consequences materialise only in the future. Sustainability departments are often go-it-alone functions regarding this topic. We know, however, that the foundations are being set today, i.e. before irreversible damage occurs because a climatic tipping point has been reached.

Climate-related risks can be classified structurally into two main categories: physical and transition-related risks.
Physical risks arise directly from climate change. They are nature-related risks that affect companies, such as raging storms followed by torrential rains that cause flooding, or heat waves that stress people. There are also transition-related risks, such as carbon pricing. These arise from the organised transition to a lower-carbon economy. Examples include political decisions, market changes and technological developments.

Companies are meanwhile no longer able to evade climate changes. The only difference will be the extent of the damage. As entrepreneurs, we have the choice to contribute more to climate protection to support the achievement of the carbon targets. If they do not do this, companies will have to deal with the consequences of climate change, including also in Europe.

This year DATEV has dealt intensively with the assessment of these risks. An interdisciplinary project team in the company has identified four key drivers. These have a direct impact on companies and are reflected in the transition-related climate risks. The objective is prevention instead of reaction. They include

- societal change;
- market-related higher energy costs;
- policy-driven higher energy costs; and
- supply chain risk.

The team focused on "market-related higher energy costs" due to the Russia-Ukraine conflict that arose in the spring of 2022 and the resulting turbulence on the electricity and gas price markets.

As an IT company, DATEV needs mainly electricity to operate its data centres and gas for the office infrastructure. As at the end of August 2022, the electricity price (gas price) reached its previous peak of over €600/MWh (€300/MWh), causing the day-ahead price to rise by a factor of 6 (9) compared to the previous year. Although the situation on both the electricity and gas price markets has eased significantly in recent weeks, with prices almost returning back to 2021 levels, high volatility and uncertainty continue to prevail. This means longer-term supply contracts will remain the exception.

The implications of higher expenditure for electricity and gas as well as price uncertainty are twofold. First, the resulting cost increases must be taken into account in internal calculations. Second, they can also be the starting point for companies in their transition towards independent, sustainable and, above all, more calculable energy sources. The range of alternatives – from an inhouse wind farm to the use of waste heat from nearby data centres – already exists today and is constantly being expanded.

The energy price risk is just one example of several transition-related climate risks that must be adequately addressed. Companies play a key role in this regard – because the alternative is physical risks posed by global warming, and once this genie is unleashed, it cannot simply be put back in the bottle.

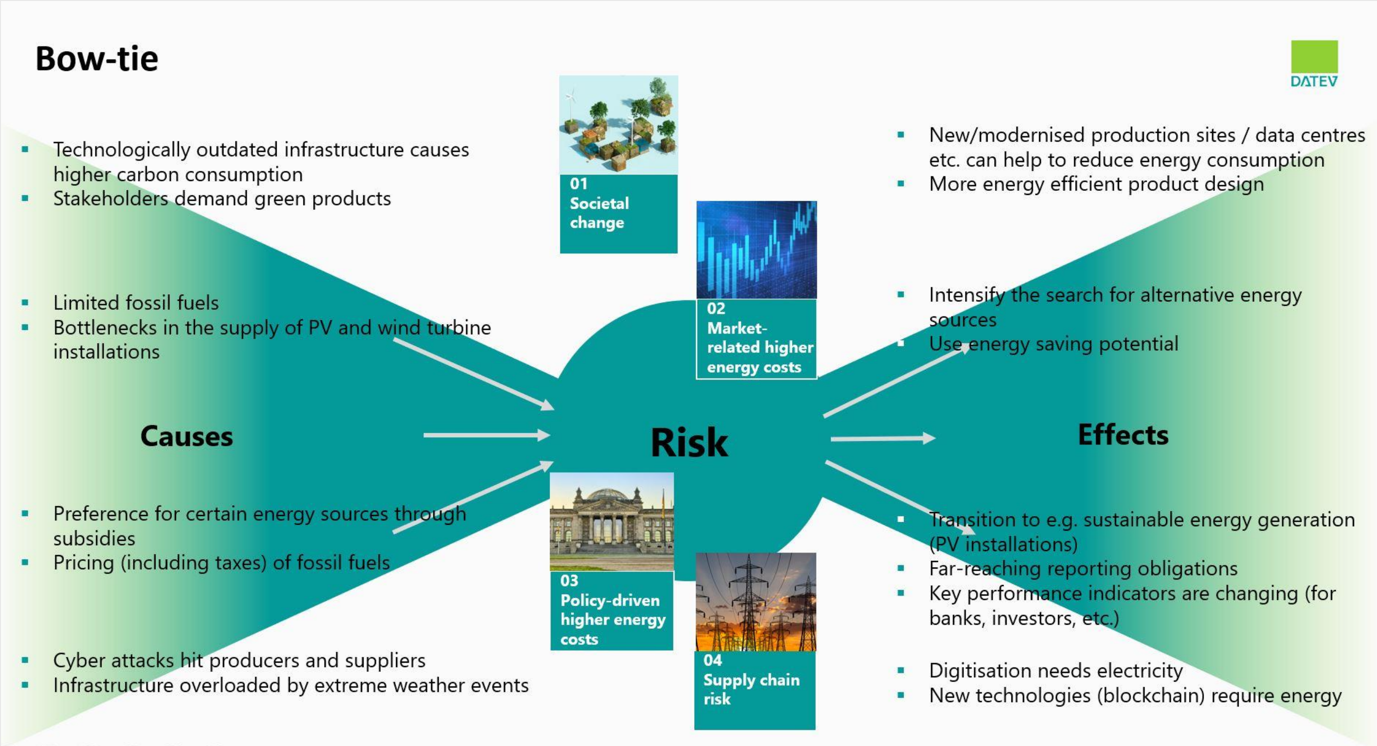


Figure 1: How Datev eG manages climate risks

Corporate sustainability reporting | Regulatory developments and implications for corporate practice

November 2022 brought two milestones in the field of corporate reporting. First, the final version of a new EU directive on sustainability-related reporting obligations, the Corporate Sustainability Reporting Directive (CSRD), was adopted. Second, proposed standards for sustainability reporting were submitted to the EU Commission. Besides the framework of corporate reporting, the standards of corporate governance in European companies are being reassessed as well.

The transition to a sustainable economic order is a political priority in the EU. Back in 2018, the EU Commission adopted its action plan for "Financing Sustainable Growth" (EU Commission, 2018), which represents a framework concept for the measures needed to achieve these goals. These were highly influenced by "sustainable finance" as a mechanism of action; under this concept, incentives for sustainable economic activity are to be set via (capital) market mechanisms – and in particular via corporate financing.

The EU's Disclosure Regulation and the Taxonomy Regulation are just two examples of measures from this action plan that are currently posing major implementation challenges for companies. Both play a significant role for the financial sector – and are key tools for redirecting future financial flows in the interests of sustainability. But in order for these standards to be effective, sustainability-related information from corporate reporting is required – i.e. about the investment objects or financing recipients in the financial sector. The Non-Financial Reporting Directive (NFRD) currently in force has failed to create such transparency.

The newly adopted CSRD addresses the three main criticisms of the NFRD: lack of completeness, comparability and reliability regarding sustainability-related information. The totality of the associated new regulations and the corresponding level of demands make this reform appear at least as ambitious as the introduction of the IFRS financial reporting standards around 20 years ago (Lanfermann/Baumüller, 2022).

The completeness of the information provided is improved because the number of reporting entities will increase significantly. It is particularly important that a reporting obligation is envisaged for all large corporations starting from the 2025 financial year. As a rule, the reporting obligation can be omitted within group structures, but coverage of all significant effects along the value chain (in terms of customers and suppliers) is required. For the first time, companies from third countries that are listed in the EU or achieve a certain volume of business on the European market have a disclosure obligation.

The completeness of the sustainability reporting is, however, also addressed by extended content requirements. Three subject areas must be covered: E(nvironment), S(social) and G(overnance). The "G-pillar" is new; it underscores that the CSRD addresses the responsibilities of the governing board and the supervisory board and evaluates them in favour of a stakeholder view.

The introduction of new standards – the European Sustainability Reporting Standards (ESRS) – serves to further specify the content and at the same time improve comparability. These new standards contain the disclosure requirements that are to be applied uniformly throughout the EU. The EU Commission now has until June 2023 to decide on a first set of standards that are to be applied to all reporting entities. Sector-specific standards and further detailed regulations have been announced for the near future. It remains unclear, however, how the ESRS can be linked to the standards of the IFRS Foundation, which will also be available soon.

Another factor that should also contribute to comparability is the new requirement that sustainability reporting must appear as a self-contained chapter in the management commentary of the annual report. As a result, the processes related to sustainability reporting and financial reporting must be harmonised, in part because of the relevant deadlines. In addition, digital tagging is required – which will lead to the provision of these data within the framework of the European Single Access Point (ESAP).

Finally, the mandatory external audit by an auditor or another service provider contributes to improved reliability. But as suitable methods and, above all, resources must still be created by the auditors, the required audit will continue to lag behind the standard of the annual audit for several years.

Sustainability is now becoming a "matter for the boss" in a large part of the European economy. In view of the great time pressure, rapid action is required!

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Insights into the CFO's perspective | Khai Tran in a lightning interview with the Think Tank about the future design of sustainability management

In order to establish sustainability effectively in the company, the overarching goal is usually integrated sustainability management. But the journey to this end poses some challenges. Khai Tran, Managing Director and Co-Founder of Valsight, has dealt with sustainability management in several companies. In a lightning interview with the ICV's Think Tank, he reports on the current status of the design of sustainability management and provides ideas for the next steps on the journey to integrated sustainability management.

ICV Think Tank: Mr. Tran, you have already dealt extensively with the design of sustainability management and in this context were able to gain an insight into the CFO's perspective at several companies. What is your impression, how far advanced are companies in the design of their sustainability management?

Khai Tran: The topic of sustainability management has in principle now arrived at the CFO's desk. How far the design has progressed depends to a large extent on how centrally the topic of sustainability is already anchored in the company's business model and its corporate strategy. However, even advanced management approaches are rarely integrated firmly into financial management. This is the long-term goal that most companies are working towards.

ICV Think Tank: The integrative management concept is now also becoming increasingly important with regard to the new regulatory requirements. What boost is the CFO function experiencing as a result of this development?

Khai Tran: First of all, the topic of sustainability has become mandatory for many companies. Even so, that is not the only motivation. Sustainability is increasingly being demanded by all stakeholders and the pressure to act is growing. One example of this pressure is the growing customer requirements for the sustainability of their suppliers.
Companies, however, can also gain something positive from this pressure. An increased focus on sustainability offers opportunities for differentiation and competitive advantages. This makes the topic of sustainability an essential component of the corporate strategy and transforms the CFO function into a key player. For example, measurement criteria for operational implementation must be derived from strategic goals, or investment projects must be evaluated against sustainability criteria.
The CFO function is therefore experiencing an enormous boost. The transition towards integrated sustainability management is lengthy, however, and most companies are still at the beginning.

ICV Think Tank: What are the next steps that companies will take to drive this transition forward?

Khai Tran: Companies that are at the beginning of their activities initially focus on providing the required data. Many simply lack the basis for sustainability measurement and therefore also its management. Companies face various challenges in this regard. This begins with the provision of the data, the uniform definition of key figures and a suitable starting point. In addition, the integration of sustainability into financial management is a key step. It is meanwhile clear that the topic of sustainability management belongs in the finance function and must be closely linked to financial management. This is the only way to implement a sustainability strategy in a systematic manner. This now also involves a new distribution of roles and responsibilities, especially regarding which organisational function will be responsible for the issue of sustainability. Although many people are still not definitively certain which role controllers will play in detail, it is foreseeable that the CFO function will continue to be a decisive force in the management of the (sustainable) corporate transformation in the future.
Personally, I hope that in a few years we will no longer be talking about "sustainability management", rather about "corporate management" – i.e. the topic of sustainability will be fully integrated into a company's management activities.

ICV Think Tank: Thank you for these insights.

Khai Tran
Managing Director
and Co-Founder of Valsight

The software, which specialises in the simulation of KPIs and scenarios, optimises and accelerates the discussion of recommendations for action and thus decision-making in financial planning and forecasting.

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Internationaler Controller Verein eV
Think Tank
Prof. Dr. Heimo Losbichler
Prof. Dr. Ronald Gleich
Stefan Tobias

Editor
Frankfurt School of Finance and Management
Dr. Kim Louisa Dillenberger
Adickesallee 32-34
60322 Frankfurt am Main
+49 69 154008382
k.dillenberger@fs.de

Think Tank's core team
Manfred Blachfellner
Prof. Dr. Ronald Gleich
Dr. Lars Grünert
Prof. Dr. Heimo Losbichler
Claudia Maron
Stefan Patzke
Prof. Dr. Mischa Seiter
Stefan Tobias

Internationaler Controller Verein eV
Office
Münchner Str. 8
82237 Wörthsee
Telephone: +49 (0) 8153 88 974 - 20
Fax: +49 (0) 8153 88 974 - 31
www.icv-controlling.com
verein@icv-controlling.com