MAKING SENSE OF ESG FOR BOARDS: AN ESG PRIMER

This paper provides a brief primer on ESG, focusing on its place in the boardroom. This primer will help Board members develop a better understanding of the needs of an organization in terms of ESG information and provide high-level tools for them to integrate ESG into decision making processes. By contextualizing the global social and environmental challenges and the current market trends that make environmental, social and governance (ESG) a source of growing importance, this primer offers a holistic summation of ESG topics that are most relevant to Boards, and provides strategic insights into how Boards can / will play a fundamental role in the future of their organization as guided by an applicable understanding of sustainability and ESG.

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INTRODUCTION

Environmental, Social and Governance (ESG) is making headlines. The $35 trillion in ESG assets under management in 2021 are forecast to exceed $50 trillion by 2025.[1]1 Broad public concern over climate change has been joined by a perfect storm of social issues, including racial injustice and inequality, to catapult fundamental questions of governance to the forefront. Governments and NGOs are heavily invested in dialogue and public policy, but these issues are critically important to business. Corporate directors need to be educated and engaged in addressing ESG topics from reputational, ethical, and cultural perspectives and better understand their impact on financial performance and value creation.

So, what is ESG? It's hard to find a good, single definition because it depends on the application. ESG might be seen as a set of environmental, social and governance criteria that investors use to screen investments. It could be seen to represent the score of a firm's collective consciousness for environmental, social and governance factors. Alternatively, a company might view ESG as a set of standards for corporate behavior to be used in formulating strategy for long-term value creation.

What can be said is that a company's ESG performance is relevant to both its present-day financial performance and its prospects for long-term value creation. Tied up in these correlations is a feedback loop with forces inside the company affecting the outside world, which is true in reverse. A company's ESG practices impact its stakeholders and shape the world around it from the inside out. From the outside in, the things that are happening today - the economic, ecological, environmental, and social dynamics of the communities in which businesses operate - loop back and impact the firm.

This is a crucial argument for the role of business in sustainability; the ESG-related efforts of corporations are both self-serving and good for everyone else. Put another way, sustainable business practice is good for business, people and the planet.

THE EVOLUTION OF ESG

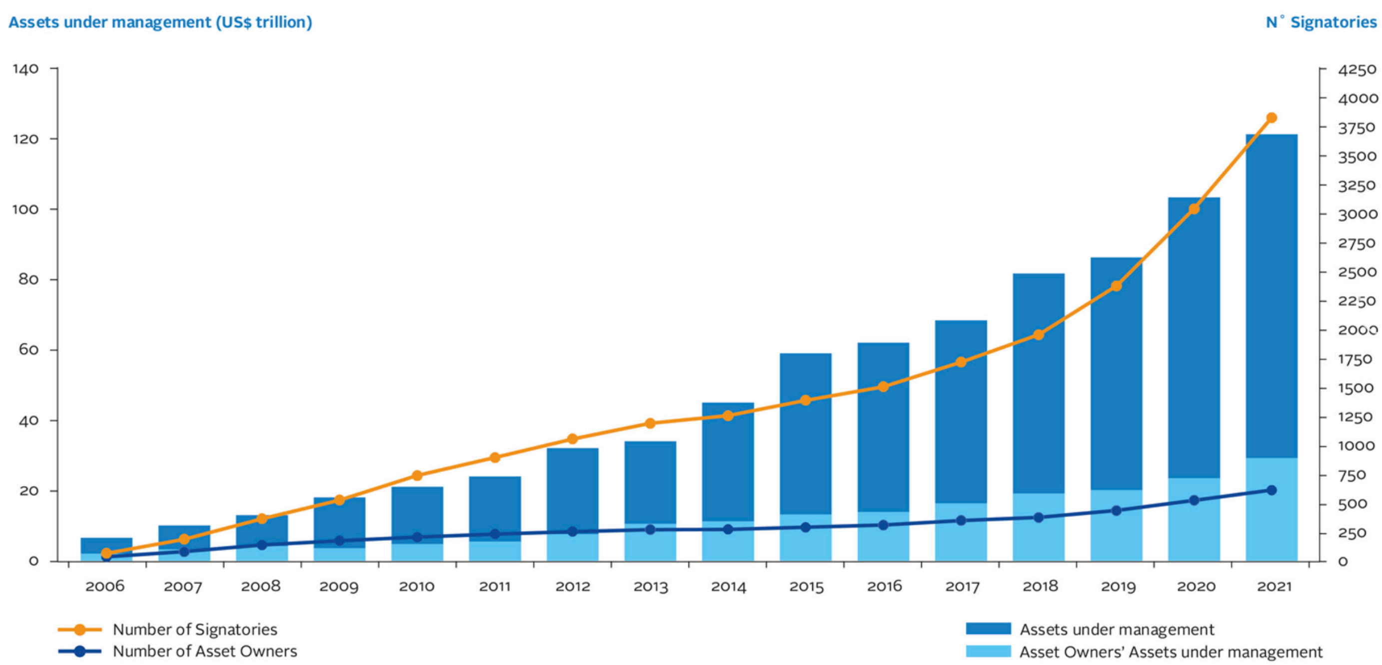
Long before the term ESG had ever appeared, the Brundtland Commission, a sub-organization of the United Nations (UN), was established in 1983 to bring countries together to pursue sustainable development. Focusing on three dimensions of development, economic, environmental, and social, the Brundtland Commission was famous for concluding "the needs of the present must be addressed in a manner that does not compromise the ability of future generations to meet their needs."[2] This has become a prevailing definition of sustainability.

In the 1990s, the Ocean Tomo report revealed the extent to which financial reporting was not capturing the full market value of firms by excluding intangible assets. The Global Reporting Initiative (GRI) attempted to guide corporate reporting of intangible assets and reflected a need for better organized and more transparent information from corporations. The “Brundtland lens” and the GRI looked at sustainability in terms of the corporation’s impacts on economic, social, and environmental dimensions. Then came the realization that the three dimensions need to be considered BOTH in terms of the company’s impact on them and their impact on the company.

In 2006, a group of large, global, institutional investors launched the Principles of Responsible Investment (UNPRI) under the auspices of the United Nations. This voluntary investor initiative is driven by mutual alignment on sustainable and responsible investing. The UNPRI was monumental because it brought the force of legal thinking and globally, aligned insitutional investors behind ESG. Following the development of the UNPRI the market has developed rapidly, led by: investor demand and initiatives, regulatory framework, global challenges, public perception, and the availability of data.

The UNPRI is the world’s largest voluntary corporate sustainability initiative. It is the leading proponent of responsible investment with a focus on integrating ESG factors into decision making. There are currently 7,000 corporate signatories in 135 countries, who are required to report annually and commit to the 6 principles.

PRI signatory growth in 2020 - 2021



Source: UNPRI 2022

In recent years, multiple forces have been at work providing momentum toward a global approach to ESG and sustainability reporting. In this time, we have seen a shift in the perception of investment professionals, understanding that there is a positive relationship between ESG and financial performance. We have further seen an increased integration of ESG backed by comprehensive and high-level commitments of investors and policy makers, as well as the increasing importance of ESG data and data integration. The UN Sustainable Development Goals (SDGs) were established in 2015, a set of 17 goals with 169 specified targets that can be assigned to the 3 broad categories of E,S and G. In 2018, the European Commission adopted an action plan on sustainable finance, which led to the 2020 EU Taxonomy Regulation that sets out overarching conditions that economic activity must meet in order to qualify as "sustainable". In 2019 the Statement of the Business Round Table was published with the signatures of 181 CEOs, redefining the purpose of a corporation to serve shareholders and create value for all stakeholders.

In 2021 following a lengthy consultation, the International Financial Reporting Standards (IFRS) Foundation announced plans to establish an International Sustainability Standards Board (ISSB). This new body will constitute a parallel organization to the International Accounting Standards Board (IASB) that develops and approves financial reporting standards for 140 countries worldwide and is also governed by the IFRS Foundation. There is every reason to expect that the creation of the ISSB will be a game-changer for global ESG disclosure and sustainability reporting and something corporate boards will need to address.

It is an interesting time in modern society, with popular trust in CEOs (61%) exceeding trust in government (57%), NGOs (53%) or media (51%), and business is the only institution being seen as both ethical and competent.[8] There has never been a bigger moment for business or a more demanding environment in which to operate. This reality has implications for boards and directors, and getting up to speed with ESG materiality, reporting and disclosure is a critical requirement.

In 2022, in response to soaring demand for ESG information, the United States Securities and Exchange Commission (SEC) proposed rules to enhance and standardize climate-related disclosures for investors. A week after the announcement from the SEC, the ISSB released two new proposals with would require companies to disclose material information about its exposure to sustainability-related risks and opportunities, climate-related risks and opportunities.

Today there is broad acceptance of the impact of ESG factors on company financial performance and valuation, but the state of ESG reporting remains immature. Multiple global ESG frameworks, guidelines, and recommendations have different orientations and metrics. There are frameworks for disclosing the impact of a company's operations on its stakeholders, reporting on metrics that are financially material to a company by industry and sector, and disclosing specifically on climate-related risk. There is also an approach for integrated financial and sustainability reporting, showing how a company creates value over time. The fragmented and inconsistent state of ESG disclosure is frustrating for companies and their stakeholders.

THE CASE FOR ESG

Some people perceive that ESG disclosures do not have a financial impact because they pertain to non-financial matters. This, however, fails to recognize that ESG incorporates a wide range of considerations and practices that relate to the ability of a firm to create value over the long term. Companies that perform well on ESG metrics typically have business models centered on the development of climate resiliency, healthy social policies and practices, and responsible, transparent governance. In this respect, ESG data is more 'pre-financial' than 'non-financial,' and its disclosure informs stakeholders about future performance and the firm's long-term viability.

Perception on ESG & performance changing

Source: EFFAS 2022

A 2020 Harvard Business Review article discussed the benefits of ESG for corporations. Benefits extend beyond the moral case and include advantages like improved employee morale and productivity, lower capital costs, the protection of company valuation, increased shareholder satisfaction with management, and the firm's ability to attract investors who support its long-term strategy.[3] The conceptual arguments presented in papers like this are well-supported empirically.

The overwhelming majority of peer-reviewed studies support a positive correlation between ESG and corporate financial performance. A 2016 study examined data on 2307 U.S. firms over 21 years and found those who made improvements in material ESG issues significantly outperformed their competition.[4] An aggregation study published in 2015 found non-negative ESG-corporate financial performance correlations in over 2000 unique studies and well over 50% positive correlation.[5] Finally, a meta-analysis on over 1000 studies conducted 2015-2020 found correlations between ESG and two types of measures of corporate financial performance. The relationship between ESG and various operating metrics (ROE, ROA) was positive in 58% of firms (negative in 8%). The relationship between ESG and stock performance was positive in 57% of firms (negative in 13%).[6]

Why does ESG drive superior financial performance? Embedding ESG into strategy paves the way for strategic competitive differentiation, but this must align with corporate purpose. Corporate purpose refers to how employees perceive the meaning and impact of their work. In embracing the purpose of the corporation as value creation for all stakeholders, the organization optimizes its chances for long-term competitive differentiation. At the core of this approach is the concept of materiality.

THE CONCEPT OF MATERIALITY

The concept of materiality speaks to what issues and topics are the most relevant to a firm and its business. Materiality is about preparing businesses to address risks and opportunities. The issues of the most significant impact in mining precious metals are not the same as those in the production of semi-conductors. What is a material ESG issue for a company is useful for making decisions.There are several different conceptions of materiality in use today:

Financial Materiality

Typically, company investors will focus on financial materiality or the issues affecting operating performance and company value, and for regulators like the U.S. Securities and Exchange Commission (SEC), information on a company is material and should be disclosed if "a reasonable person would consider it [the information] important."[7] Financial materiality is a case of single materiality, with its single-minded focus on investors' interests in securing accurate financial information. In recent years thanks to the efforts of groups like the Task Force for Climate-Related Financial Disclosure (TCFD), it is widely acknowledged that climate-related impacts on a company can be material and warrant disclosure.

ESG Materiality

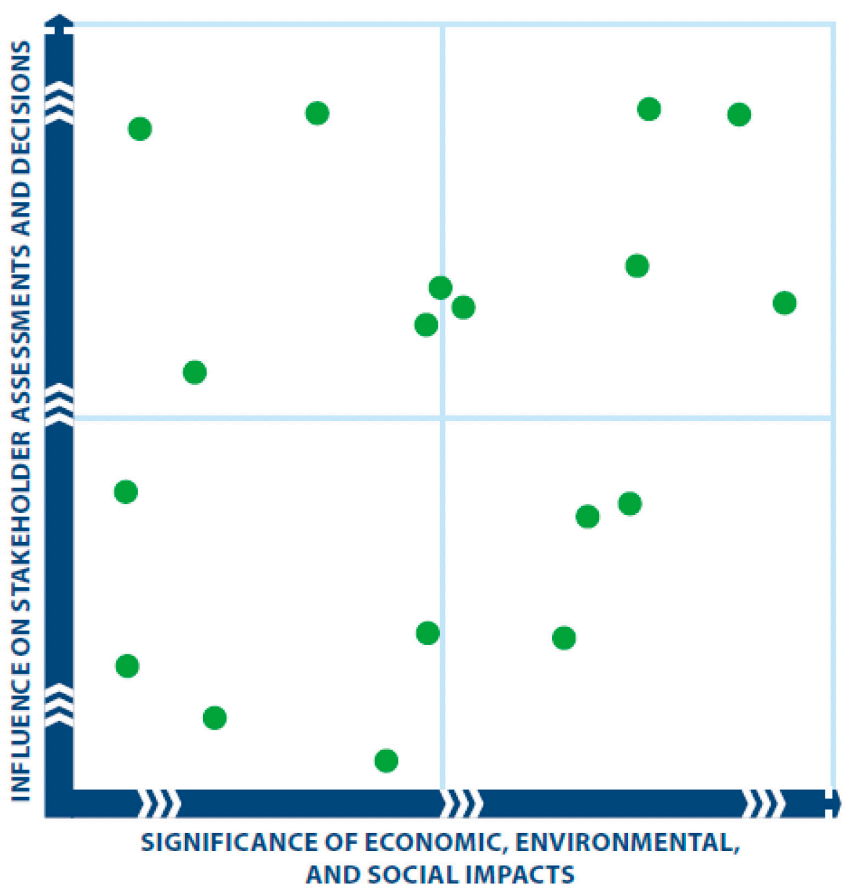
Based on the financial concept of materiality, the threshold of ESG materiality is topics beyond which ethical, social, or environmental topics are considered relevant and significant for the company to disclose.

Double Materiality

The focus is on all stakeholders and not only investors. It is the broader impacts of a firm or the economic, social and environmental byproducts of its business practices that are material. In this sense, materiality is more akin to an externality and bound up with the positive and negative impacts of the business on all its societal stakeholders. The notion of double materiality is an extension of financial materiality, recognizing it is not only climate-related impacts that may be material but also the firm's impacts on any factor of sustainability, be it an economic, environmental, social or governance-related concern.

The concept of 'double materiality' was first proposed in 2019 by the European Commission. It expands the perspective of materiality to include actions from the inside-out and outside-in by requiring environmental and social material perspectives and financial material perspectives to be included in decision making with careful consideration of their interactions.

Double materiality is commonly applied, and most easily understood, using a **materiality matrix:**



The materiality matrix is a tool used to display key sector-based ESG materiality issues. The 'x' axis represents the signifigance of ESG impacts, where the 'y' axis represents the influence of stakeholder assessment and decisions. The plot points situated in the top-right quadrant define the materiality issues of priority.

Source: GRI - Global Reporting Iniative

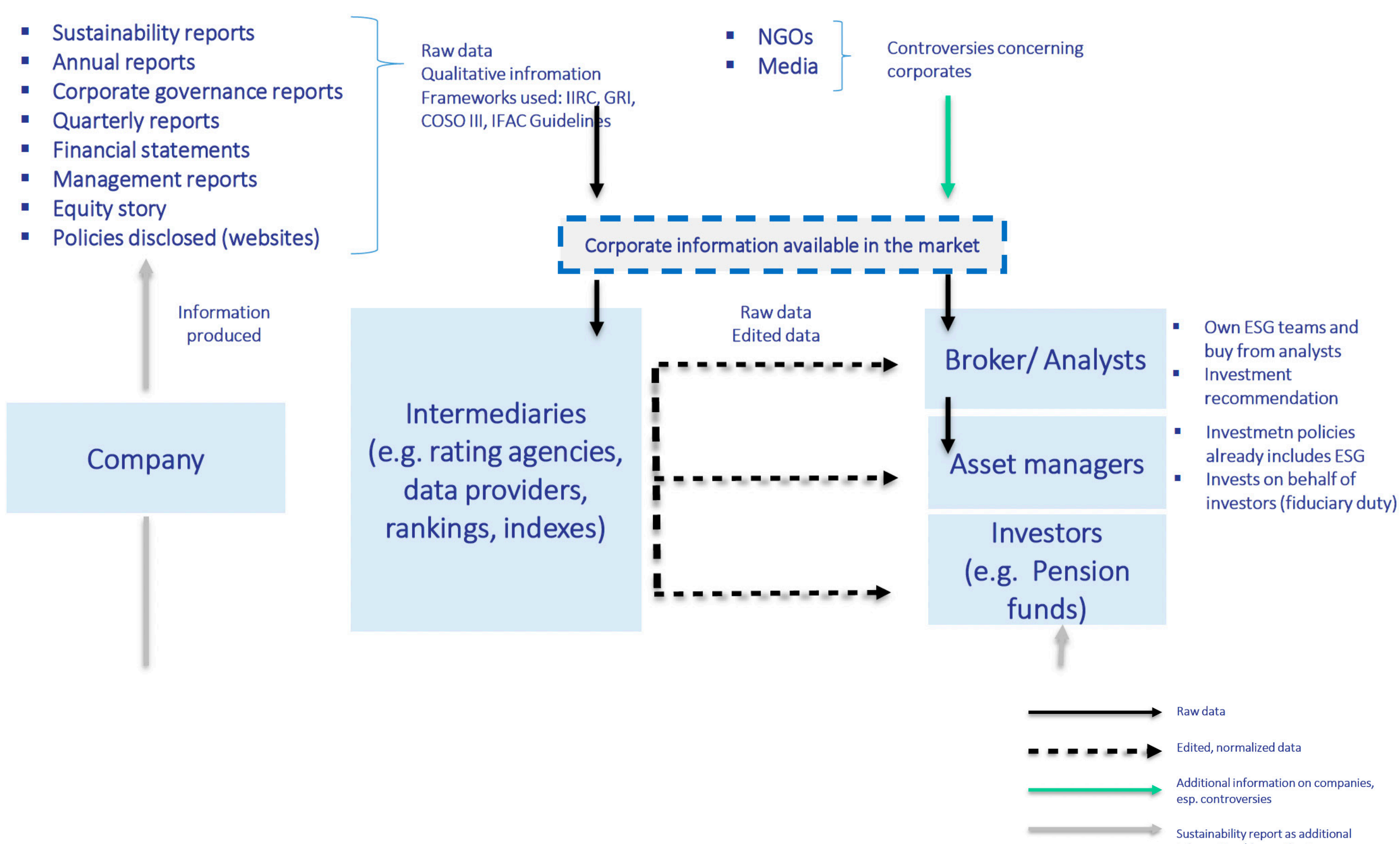
ESG REPORTING AND DISCLOSURE

For any company, the practice of ESG should start with strategy. From strategy, the material ESG issues facing the business can be determined, both the opportunities and the risks. Most commonly, this is done by analyzing stakeholders and their interests. There are numerous ESG standards and frameworks for reporting. Companies new to ESG may want to pick one as a starting point. With material issues identified, KPIs for sustainability can be established, and reporting can take place against a recognized standard.

A company reporting on ESG is both relevant and advantageous because markets are demanding transparency. Companies are not isolated, rather, they serve different stakeholders who require symmetry of information.

Investment decision-making is based on raw data available in the marketplace. ESG disclosures enable companies to produce the data that is being processed by intermediaries and offered to the market.

Information flow: Investment making decision process from ESG data



Source: EFFAS 2020/Albrecht et al. 2018

ESG Frameworks

» **Global Reporting Initiative (GRI)**
The GRI is stakeholder-focused and facilitates disclosures on the most material economic, environmental, and societal impacts arising from corporate activities, including impacts on the business and on stakeholders.

» **Climate Disclosure Standards Board (CDSB)**
CDSB provides a framework for reporting climate and environmental information in a mainstream report and to relate these to organization strategy, performance, and prospects.

» **Climate Disclosure Project (CDP)**
A global environmental disclosure system supporting companies, cities, states, regions to measure and manage risks and opportunities on climate, water, and deforestation

» **Task Force for Climate-Related Financial Disclosure (TCFD)**
A set of recommendations for climate-related financial disclosure to support better informed capital allocation with four pillars: governance, strategy, risk management and metrics and targets.

» **Sustainability Accounting Standards Board (SASB)**
SASB is investor-focused and provides a set of standards that outline the ESG issues that may have financial materiality on an industry-specific basis to allow businesses to identify, manage and communicate them

» **International Integrated Reporting Council (IIRC)**
The primary purpose of an integrated report is to explain to financial capital providers how an organization creates value over time. This is done through a combination of qualitative and quantitative information pertaining to six capitals:
financial, intellectual, manufactured, human, social and relationship and natural.

» **Value Reporting Foundation (VRF)**
SASB and the IIRC merged in 2021 to become the VRF

Intermediaries

A critical part of developing an ESG strategy is understanding the role of third-parties (intermediaries) and ESG ratings. In the European market in particular, third-parties are necessary for ESG integration into investment decisions. For example, from an investment approach and strategy perspective, there is an increased appetite from stakeholders to use ESG data to narrow down an investment portfolio. There are also investment strategies that review best-in-class companies and would use ESG Risk Ratings offered by intermediaries to exclude companies in the bottom 25th percentile of an industry, subindustry, or region.

With an increased demand for transparency and accountability, intermediaries are trusted to verify and monitor a company's ESG-related matters, events and controversies as well as assess existing policies and procedures. Having an ESG Risk Rating from an intermediary is increasingly a requirement for investment decisions.

There are a number of third party ESG ratings agencies and data sources. To provide a comprehensive list is beyond the scope of this paper, but some of the better known include Bloomberg ESG Data Service, Corporate Knights Global 100, DowJones SustainabilityIndex (DJSI), Institutional Shareholder Services (ISS), MSCI ESG Research, RepRisk, S&P Global, Sustainalytics, Thomson Reuters ESG Research Data and Vigeo Eiris.

Source: EFFAS 2022

The Future of ESG Reporting

The world is on the cusp of a major development in expectations for corporate reporting. The current ecosystem of fragmented and inconsistent ESG standards and reporting frameworks will yield comprehensive, global approach to sustainability reporting. We have seen lots of improved coherence in reporting since 2018 with the EU Taxonomy. With the overarching goal of enhanced transparency, this trend to align reporting frameworks is making noise. From the business perspetive, teams require an evolution from the complexities and inadequacies of current reporting frameworks, especially if the reporting standards expected of companies continue to deepen. The 2021 undertaking of the IFRS Foundation to set up the International Sustainability Standards Board as a global body for sustainability reporting represents a profound step. This marks a continuation of bilateral efforts to develop greater consistency in ESG standards-setting and disclosure.

Several recent events have punctuated the march towards unification. In late 2020 the ‘Statement of the Big Five’ ESG standards-setting agencies (GRI, SASB, the CDSB, CDP and IIRC) to work together towards comprehensive corporate reporting provided a significant boost. Shortly after that, the World Economic Forum (WEF) and the “Big Four” accounting firms (Deloitte, EY, PwC and KPMG) released a universal set of ESG metrics and disclosures to establish a single global ESG reporting standard. In response to these initiatives, the IFRS Foundation Trustees published a consultation paper to collect input regarding establishing an International Sustainability Standards Board within its governance structure. By June of 2022, the IFRS Foundation will have consolidated the CDSB with the Value Reporting Foundation (previously SASB and the IIRC).

In March of 2022, in response to soaring demand for ESG information, the United States Securities and Exchange Commission (SEC) proposed rules to enhance and standardize climate-related disclosures for investors. This proposal, if successful, will “require registrants to include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements. The required information about climate-related risks also would include disclosure of a registrant’s greenhouse gas emissions, which have become a commonly used metric to assess a registrant’s exposure to such risks.”[9] A week after the announcement from the SEC, the ISSB released two new proposals which would require companies to disclose material information about it's exposure to sustainability-related risks and opportunities, climate-related risks and opportunities.

There is no doubt that we are moving towards globally aligned, mandated, sustainability disclosures. ESG integration is no longer a nice-to-have for organizations, rather is a need-to-have that will distinguish clear laggards, forerunners, and pioneers. It is not just possible but likely that within a few years, the world will have a functioning ISSB setting standards for sustainability reporting, just as happens today with financial reporting.

THE BOARD'S ROLE IN SUSTAINABILITY AND ESG

The main question boards should be asking themselves is: *are we keeping up with this?*
Boards must have the agility in their decision making for a potential transformation and prove that their means are commensurate with their ESG objectives.

The board's role in the financially material concerns of the business is not a matter of debate, but the same is not true of material ESG topics. Despite well-established conceptual arguments and empirical data supporting the relationship between ESG and corporate financial performance, most boards are not on top of this. A 2018 NYU Stern study examined the credentials of 1188 Fortune 100 board directors and found only 29% had relevant ESG credentials.[10] A 2019 PwC survey of over 700 public-company directors revealed that 56% thought boards were spending too much time on sustainability topics. While there are several explanations, the bottom line is that boards who have not incorporated ESG into their thinking need to get on it in service of corporate purpose, long-term business viability and profits.

In March 2021, Allison Herren Lee, then-acting Chair of the SEC, delivered a speech recognizing the unprecedented shift of investor focus toward analyzing and using climate and other ESG risks and impacts in investment decision-making.[11] Reflecting the core mission of the SEC to ensure provision of climate and ESG information to the markets promptly, Lee acknowledged the drawbacks of the current voluntary reporting framework and announced SEC intentions to develop a comprehensive ESG disclosure framework which we are now seeing. Whereas ESG practice and disclosure may be an option for those boards at the frontiers of governance, it won't be forever.

In a recent Harvard Business Review article, Eccles et al. (2020) argue it is 'corporate purpose' that provides boards with the impetus to enhance their focus on ESG and propose a concise framework doing so.[12] The SCORE framework stands for Simplify, Connect, Own, Reward, Exemplify. The nuts and bolts of SCORE involve simple articulation of corporate purpose, connecting purpose to capital asset allocation, ownership of the responsibility for supporting structures and processes, establishing the metrics for remuneration and exemplifying purpose through integrated financial and sustainability reporting.

The limited uptake of purpose and ESG-driven strategy in boardrooms has been explained differently. Still, questions around the tension between relative shareholder and stakeholder importance are central, and closely related to that is the matter of timeframe. Shorter time horizons – and some would say quarterly reporting – may be inclined to encourage investment decisions that optimize near-term performance at the expense of longer-term growth and durable competitive advantage. Investors are waking up to the perils of 'short-term-ism' and wanting to understand companies' prospects for long-term financial returns. The growing concern over stranded assets in the energy sector is an example of this, with investors demanding to see firms' plans for the energy transition. These plans are not just a matter of financial return but organizational viability. Board directors will need to be responsive to this, and therefore to the raison d'etre for their firm's existence, its corporate purpose. And this means considering the material interests of all the firm's stakeholders.

As the global economy has shifted from its historical industrial base towards growth in knowledge and service-based business, there has been a corresponding rise in the relative value of intangible versus tangible assets. Whereas tangible assets are things like buildings, equipment and inventory, intangible assets have been described as 'anything you cannot touch' and include things like data systems, design expertise, intellectual property, and brand investment. Organizations possess intangible assets because of investments they make today in knowledge, people, and systems, that are expected to create a future return. As such, intangible assets are understood to relate directly to long-term value creation and investors are increasingly focused on disclosure of these pre-financial or extra-financial assets, in addition to traditional financial disclosure. Today there is a push to incorporate the material ESG factors into corporate disclosure.

The main question boards should be asking themselves is: are we keeping up with this? Boards must have the agility in their decision making for a potential transformation and prove that their means are commensurate with their ESG objectives. As the top leadership of an organization, it is the board's responsibility to support an ESG strategy and to ensure that sufficient resources are allocated to the strategy.

LOOKING AHEAD FOR BOARDS

In thinking about the tectonic shifts that have reshaped sustainability reporting in recent years, what is striking is the significant chasm that persists between investors and firms. There is a generous gap between investor support for stakeholder capitalism and how well investors think corporations deliver it. How invested are the boardrooms of the 181 signatories to the 2018 BRT Statement of the Purpose of a Corporation? What progress has been made toward the promise of stakeholder capitalism? Investors, consumers, and regulators are placing pressure on corporations. They want to know how a firm invests in its employees, their health and safety, in the customer experience, the communities where they operate, and the planet itself. These are increasingly seen as requisites for the creation of long-term value and preservation. Boards who fail to understand this, who don't take ownership of corporate purpose or oversee the establishment of appropriate organizational structures and processes, will suffer economic, reputational, and regulatory setbacks.

A concluding question about the board's role might be why ESG isn't discussed on more quarterly reporting calls? It's fair to say that analysts don't need to know the minutiae of a firm's environmental impact, but they need to know the climate strategy, including targets for the future and plans to get there. Analysts and the investors they guide need to understand how a firm's strategy is to open opportunities, reduce risk and improve efficiency.

In an industry that is so nascent, yet increasingly dynamic and evolving at a rapid pace, ESG integration may be thought of as learning to play the game of tennis while simultaneously creating the rules of the game. Naturally, this places boards in a seemingly impossible position where they are required to stay on top of a trillion-dollar phenomena that hardly turned-heads until five years ago.

The challenge for boards looking forward will be to balance the traditional press for short-term financial performance that has always been their purview, with an increasingly powerful societal ambition for firms to deliver value in the long-term, operating as good corporate citizens and responsible stewards of the planet. Boards should be taking the lead on corporate purpose with an eye on the long-term horizon of the business.

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