Measuring ESG to manage and drive sustainable change

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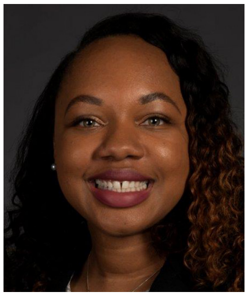

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Introduction

Long before the acronym "ESG" (environmental, social, and governance) was coined, select organizations around the world reported on sustainability efforts every year. Whether related to the elements of environmental, social, or governance efforts, the subsequent reporting was largely self-governed.

Those days of self-governance are ending: the U.S. Securities and Exchange Commission (SEC) and global regulators are taking steps to protect investors and ensure that standards are better defined and upheld. Consistency and clarity are the goals, safeguarding that organizational ESG reporting is not misleading or fraught with misrepresentations for investors and other stakeholders.

Driving the change

Enforcement actions by regulators across the globe—including the United Kingdom Competition and Markets Authority and the SEC, along with civil suits and complaints by non-governmental organizations (NGOs) alleging "greenwashing"—continue to make headlines. Increased stakeholder expectations and scrutiny are adding to the mix—whether from customers, employees, or lobby groups; this adds to a heightened level of activism and demands greater transparency and integrity of action.

What actions can organizations take to get ahead of looming regulations? In a bid to end "greenwashing"[1] and "greenwishing,"[2] or the appearance thereof, companies need to develop, measure, monitor, report, and audit ESG metrics to gain confidence that they are not making misrepresentations and are indeed meeting the requirements and scrutiny of global regulators. Organizations should leverage their compliance teams, internal audit, and other relevant control functions to lead the design, implementation, and monitoring of processes and internal controls to ensure that the data being reported related to ESG metrics is accurate and complete. Together with the business, the control groups should also review company policies along with any related disclosure made.

Consistency

- Do you need a glossary with definitions to make sure everyone understands the terms the same way?
- Where calculations are occurring, is everyone using the same methodology?
- Is everyone capturing the data the same way?
- What is the unit of measurement being used?

Evolution and current regulatory landscape: ESG is here for the long haul

The desire for businesses to "do good" or go beyond profits has existed. Over the course of recent history, efforts have evolved and manifested in different ways, including:

- **Corporate social responsibility (CSR):** How organizations develop and communicate their activities which are designed to have a positive impact on society. With roots in the idea that businesses operate with a license from society, CSR is driven by the organization, while ESG is how external parties evaluate an organization based on how it handles these three elements (environmental, social, governance).
- **Sustainability:** Focuses on operating in a way that preserves resources for long-term use. Beyond environmental impacts like climate change, pollution, deforestation, and rising water levels—among others—sustainability encompasses how businesses impact people and communities and their continued economic viability. Essentially, an organization's CSR strategy and how third parties rate their ESG strategy are different ways of viewing how it supports and focuses on sustainability.
- **Socially responsible investing:** Organizations that or individuals who invoke socially responsible investing seek financial returns while aligning their investments with their moral and social values. ESG, as it is known today, has roots in socially responsible investing.

While the nomenclature has varied, the core principles behind these movements have resonated and continued to evolve in the mind of consumers and investors alike. As such, they have also grabbed the attention of another key stakeholder: global regulators.

Regulation looms

After years of near self-governance and nonstandardized approaches to nonfinancial reporting, greenwashing and greenwishing have emerged on the radar, and regulators have tightened their scrutiny; they are making changes to ensure standards are more explicit.

Regulators are developing rules to protect consumers and force clarity to help investors make informed investment decisions in a sea of potentially misleading or confusing data and reporting. While the SEC's proposed standards and European Union's (EU) Corporate Sustainability Reporting Directive suggest similar enhancements to ESG disclosures, the SEC's rulemaking remains in discussion, and the EU's Directive is expected to be adopted in late 2022, with subsequent rules planned through 2050.

The EU Directive will require public sustainability reporting by impacted companies accompanied by an assurance report covering disclosed data. This directive is far-reaching and will impact not just EU-based companies but also those foreign companies that meet an activity volume threshold in the EU. The countdown is on for companies to get their house in order: once adopted, the rule should be in effect in 2024 for most companies.

Aligning ESG metrics with business strategy

In examining how an organization will meet regulatory obligations, leadership should consider how ESG fits into the broader strategy for long-term business success. ESG factors are increasingly critical in underpinning corporate strategy, disclosure considerations, and business operations. Companies must develop and refine their ESG strategy and priorities, embedding these into the corporate strategy to become integrated and purpose-led.

Develop metrics

Consider ESG a long-term endeavor that will drive value creation and sustainable growth. As stakeholders continue to define which ESG elements are most important to them based on risk profile and appetite for transformational change, leaders should start by conducting ESG risk assessments to identify factors most relevant to their organization's business objectives. Added value comes from engaging stakeholders to understand which metrics will be key to the desired impact.

Each strategic strand of E, S, and G has its own unique set of vital metrics that should be focused on achieving goals. When correctly identified, these goals will not only represent an aspiration for the business across its sustainability agenda but will also drive measurable change in the way the business operates and makes decisions.

Once the goals have been identified, the next step is to consider informally benchmarking them against similar goals at other companies of the same industry; leverage standards or benchmarks set by industry groups, NGOs, and networking groups; and consult with experts to determine how to align these with your business' needs and values. At each stage, consider if goals are achievable and if not, why not? Which direction does the company need to move in to make ESG strategies actionable and achievable? This is easier with short-term goals, but many ESG goals are aspirational, like carbon neutrality and net-zero emissions. It may not yet be clear how to achieve these, but companies cannot afford to passively wait for the innovation that will get them over the finish line. They need to actively explore and review developments and progress on all of their goals.

Finally, companies should formalize a procedure document that lays out the logic, methodologies, and ideals of the ESG framework, which helps with buy-in and clearly outlines the metrics and goals as strategic commitments, prioritizing those higher areas of risk across the sustainability strategic agenda.

Data Storage

- Who is the responsible party for each data set for each metric in each business unit/division/region, etc.?
- Is there more data available than you can see on reports? What is the best way to access the data in a recurring fashion?
- Can you centralize the data capture to make it more accessible?
- Where is the support stored?

Understanding—and measuring—the data

As with most things, "if it doesn't get measured, it doesn't get done." ESG principles are the same. The assessment and measurement of data for quality, accuracy, completeness, and consistency are critical. Key considerations should include:

- Collaborating with IT, finance, operations, human resources, legal, internal audit, and risk to identify the data available to support the metrics and how it can be accessed. This discussion should be expanded to have a 360-degree view of the company and all available data.
- Developing a "data book" with a definition and calculating methodology for each element, including units of measure (e.g., gallons versus liters, US dollars versus Euro) and reporting periods (i.e., billing period versus data of invoice versus date of payment). The data book should have all the information an auditor would need, so if there are limitations or clarifications to the data, make sure these are clear.
- Designing and assessing internal processes and their internal controls around the financial and nonfinancial reporting data that will be disclosed.
- Identifying areas for enhancement to improve the accuracy and completeness of the disclosed information.
- Building cross-functional accountability for maintaining the data.
- Extrapolating—where required, memorializing any assumptions to support validity of approach.
- Training personnel on the processes, including common pitfalls, to support gathering accurate and complete data.
- Reassessing these processes periodically so changes that may impact reporting are caught and addressed early.

Monitoring and reporting progress against ESG metrics

Companies must identify ways to monitor and communicate progress toward goals to key stakeholders and regulators. Investors and customers will use this information to identify those companies committed to the changes they want to see in the world. Suppliers can also use it to understand how they will align with an organization's standards to be successful long-term.

Importantly, many investors will look to the progress of these goals as signals of a company's health—i.e., is the management team doing what it said it would do? Does the management team have the authority to make the necessary changes?

Senior leaders must ensure the organization is living its strategy through purpose-led decision-making, regular progress communication, and managing eventual trade-offs. The strategy cannot be "set it and forget it"; rather, it will only become meaningful when activated through actions and behaviors.

To live the strategy, leadership should:

- Consider how information is shared within their company. Who needs to know? Do all accountable parties understand how they or their role is vital to the ESG strategic goals?
- Periodically report to the executive leadership team and board of directors against targets and consider additional sharing through vehicles such as annual reports and sustainability reports.
- Remain cognizant of whether incentives and pressures related to achieving targets and metrics support—not inhibit—employees from doing the right thing.

- Utilize data to identify red flags that may hinder progress toward targets and metrics that may be misleading.

Completeness and accuracy

- Are there any estimates? What methodology are they based on?
- If you rely on a report or consolidated data, have you tested it to make sure it is accurate and complete?
- How fresh is the data? Is it a live feed that updates overnight, or is it only as new as the last time someone had time to sit down and do data entry? How do you know it is complete?
- If you pull 12 months of data, is that the period covered by the bill, the invoice date, or the payment date?
- If multiple currencies are involved, what foreign exchange rates are being used for conversion?

Don't forget to audit!

Auditing provides assurance that the data captured by processes and internal controls and used in reporting is accurate and complete. Traditional audit activities focus on financial data. ESG reporting relies largely on nonfinancial data. Companies should adopt the same approach to mitigating reputational risk related to ESG through this third line of defense. Looming regulations will require third-party attestation around some ESG metrics; however, companies should subject all ESG metrics to auditing procedures and techniques designed to validate the accuracy and completeness of the information. Compliance and internal audit have experience balancing different regulatory risks and requirements and proven systems for measurement, reporting and auditing, and can be of great value in leading this process.

Conclusion

ESG, CSR, or sustainability: the name may change, but the sentiment endures. The passion around ESG is getting stronger and is considered by many as a license to operate in the world today. Stakeholders want businesses to act ethically, and they want assurance that what is being said is what is really happening.

Investors are seeking meaningful understanding of an organization's ESG programming. Applying measurement is the clearest way to do so; this begins with understanding what is vital to measure and what an organization can measure. ESG is a strategic business priority; organizations must prepare to meet and even exceed regulatory requirements to come.

Takeaways

- Develop metrics that align with company values, are important to stakeholders, and meet regulatory requirements.
- Engage with key stakeholders to develop relevant ESG metrics and create accountability for the strategic commitments being made.
- Document assumptions and memorialize the specifics of the data being measured and reported.
- Design, assess, and audit the processes and internal controls that generate the data to be disclosed.
- Regularly review how and where communications need to be shared to be most impactful to the company's strategy.

1 *Greenwashing* is "the act or practice of making a product, policy, activity, etc. appear to be more environmentally friendly or less environmentally damaging than it really is," *Merriam-Webster Online*, s.v. "Greenwashing," accessed October 17, 2022, https://www.merriam-webster.com/dictionary/greenwashing.

2 *Greenwishing* reflects the good intention of business initiatives that ultimately do not result in any impact.

Mark Trexler, "From Greenwishing To Greenwashing – A Growing Business Risk?" GHG Management Institute, accessed October 17, 2022, https://ghginstitute.org/2019/10/17/from-greenwishing-to-greenwashing-a-growing-business-risk.

3 European Commission, ***Directive Of The European Parliament And Of The Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting***, accessed October 17, 2022, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0189.

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