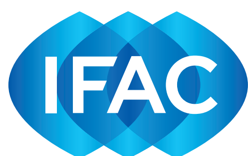
INVESTOR DEMAND FOR ENVIRONMENTAL, SOCIAL, AND GOVERNANCE DISCLOSURES:

IMPLICATIONS FOR PROFESSIONAL ACCOUNTANTS IN BUSINESS



International
Federation
of Accountants

The mission of the International Federation of Accountants (IFAC) is to serve the public interest by: contributing to the development, adoption and implementation of high-quality international standards and guidance; contributing to the development of strong professional accountancy organizations and accounting firms, and to high-quality practices by professional accountants; promoting the value of professional accountants worldwide; speaking out on public interest issues where the accountancy profession's expertise is most relevant.

The Professional Accountants in Business (PAIB) Committee serves IFAC member bodies and professional accountants worldwide who work in commerce, industry, financial services, education, and the public and not-for-profit sectors. Its objectives are to promote and contribute to the value of professional accountants in business by increasing awareness of the important roles professional accountants play in creating, enabling, preserving, and reporting value for organizations and their stakeholders; and to support member bodies in enhancing the competence of their members to fulfill those roles. These objectives are achieved by facilitating the communication and sharing of good practices and ideas.

Copies of this publication may be downloaded free of charge at www.ifac.org/paib.

Exposure Drafts, Consultation Papers, and other IFAC publications are published by, and copyright of, IFAC.

IFAC does not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

The IFAC logo, 'International Federation of Accountants', and 'IFAC' are trademarks and service marks of IFAC.

Copyright © February 2012 by the International Federation of Accountants (IFAC). All rights reserved. Permission is granted to make copies of this work provided that such copies are for use in academic classrooms or for personal use and are not sold or disseminated and provided that each copy bears the following credit line: "Copyright © February 2012 by the International Federation of Accountants (IFAC). All rights reserved. Used with permission of IFAC. Contact permissions@ifac.org for permission to reproduce, store or transmit this document." Otherwise, written permission from IFAC is required to reproduce, store, transmit, or make other similar uses of this document, except as permitted by law. Contact permissions@ifac.org.

ISBN: 978-1-60815-111-0

Published by:

Key Findings

TO WHAT EXTENT ARE INVESTORS USING ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INFORMATION?

- Environmental, social, and governance (ESG) information is increasingly used by investors to understand an organization's key ESG factors and how they impact overall performance over a longer time horizon. This is evidenced by four factors.
  - The number of investors signing the United Nations (UN)'s Principles for Responsible Investment.
  - The increasing number of shareholder proposals comprising environmental, social, or governance resolutions.
  - Surveys of investors that indicate an increasing number believe that ESG integration into the investment process maximizes beneficiaries' long-term interest, and that good governance and sustainability practices contribute to the creation of long-term shareholder value.
  - Research that shows how investors incorporating ESG information and analysis in their investment processes can outperform their peers.
- Investors have an important role to play in promoting long-term sustainable organizational success, even though they represent only one element of an effective corporate governance system. However, a lack of attention to ESG factors, and the passivity and short termism of some investors, can contribute to short-term thinking by companies.

WHAT DRIVES SOME INVESTORS TO BE SHORT-TERM IN THEIR PERSPECTIVES AND ACTIONS?

- The nature of short termism is hard to define. There is criticism of the shortening of stock-holding periods of many investors, as well as their readiness to take short-term investment positions, which may lead to short termism in companies. However, more significant challenges prevent institutional investors, who theoretically should take a longer-term perspective, from taking such a perspective and promoting ESG in companies in which they invest. The challenges include incentives that deter many from pursuing a stewardship role based on engagement; an investment chain that has lengthened by outsourcing management; and a lack of recognition that ESG factors influence an organization's ability to deliver adequate long-term cash flows and returns.

WHAT ARE THE INVESTMENT APPROACHES USED TO INCORPORATE ESG FACTORS?

- An increasing number of investors with a responsible investment philosophy are progressing beyond negative (excluding specific industries or sectors from an investment portfolio) and positive (using external ratings to select "best-in-class" investments) screening of companies. They are proactively encouraging companies through engagement and dialogue with the aim of improving the company's value through greater incorporation of ESG factors into their investment processes. Such engagement leads to greater integration of specific ESG information and criteria into financial valuations associated with a company. This correlates with research indicating that an increasing number of investors, in some jurisdictions, are prepared to sacrifice some short-term performance to better manage long-term risks.
- Challenges to mainstreaming ESG issues remain mainly because many investors perceive ESG issues as being complex and, therefore, difficult to articulate, assess, and integrate into investment decisions. This complexity is also driven by perceived inconsistencies and insufficiencies in ESG disclosures by companies. The result is that many investors marginalize ESG issues so they are treated with a compliance mentality rather than with a mindset that fosters the formal appraisal and measurement of material ESG factors.

WHAT INFORMATION AND DISCLOSURES ARE INVESTORS INTERESTED IN?

- Investors typically have proprietary approaches and models for assessing companies, but many seem to be gravitating to certain types of disclosures and key performance indicators, which are set out in Appendix 1.
- Approaches to valuation and monetization are getting more sophisticated. Investors can assess financial outcomes of various ESG factors in terms of changes to cash flows and earnings impact, cost of capital, and asset values. They will, therefore, focus on material ESG factors and metrics related to the drivers of competitive advantage and sustainable value creation of a sector or individual organization that will ultimately drive financial performance.

WHAT ARE THE IMPLICATIONS AND LEARNING POINTS FOR THE ACCOUNTANCY PROFESSION AND PROFESSIONAL ACCOUNTANT IN BUSINESS?

- Professional accountants need to support their organizations in meeting an increasing investor demand for ESG information. They will need to ensure that both the organization and its investors receive a complete and relevant picture of organizational performance and impacts. Professional accountants should be well placed to bring the discipline and application of accounting rigor to the collection, analysis, and reporting of ESG data, and support the incorporation of ESG factors into an organization's management processes and systems.
- Five key recommendations provide guidance on how the accountancy profession needs to respond to great investor interest and awareness of ESG factors.
  - Engage investors effectively to determine their ESG information needs to better communicate performance.
  - Incorporate ESG factors and non-financial performance information into governance and accountability arrangements to improve information and disclosure quality.
  - Link financial and non-financial performance and outcomes to improve understanding of sustainable value creation.
  - Ensure that ESG disclosures meet investor needs by being material, timely, consistent, and comparable in order to improve usefulness of reporting and greater transparency.
  - Bring together data that may be dispersed in different parts of the organization or its supply chain to support internal and external decision making.

Table of Content

INTRODUCTION 6

ESG—WHAT'S IN A NAME? 8

Defines ESG within the context of other commonly used terms, such as sustainability

INVESTOR TYPES AND PERSPECTIVES 9

Identifies various types of investors and the time horizons of institutional investors

CURRENT DEMAND FROM INVESTORS FOR ESG INFORMATION AND DISCLOSURE 11

Reviews the demand for ESG information from investors and highlights an evolving trend toward greater interest in ESG factors

INVESTOR APPROACHES TO DEALING WITH ESG FACTORS 14

Highlights investor approaches to secure information on ESG factors covering negative and positive screening, engagement, and ESG integration

WHAT SPECIFIC ESG PERFORMANCE INFORMATION AND INDICATORS DO INVESTORS SEEK? 16

References the specific ESG performance indicators and metrics that investors seek and analyzes how investors consider the financial implications and monetization of ESG factors

IMPLICATIONS OF MANAGING AND REPORTING ESG PERFORMANCE FOR THE PROFESSION 19

Focuses on the implications and learning points for professional accountants in business and the accountancy profession

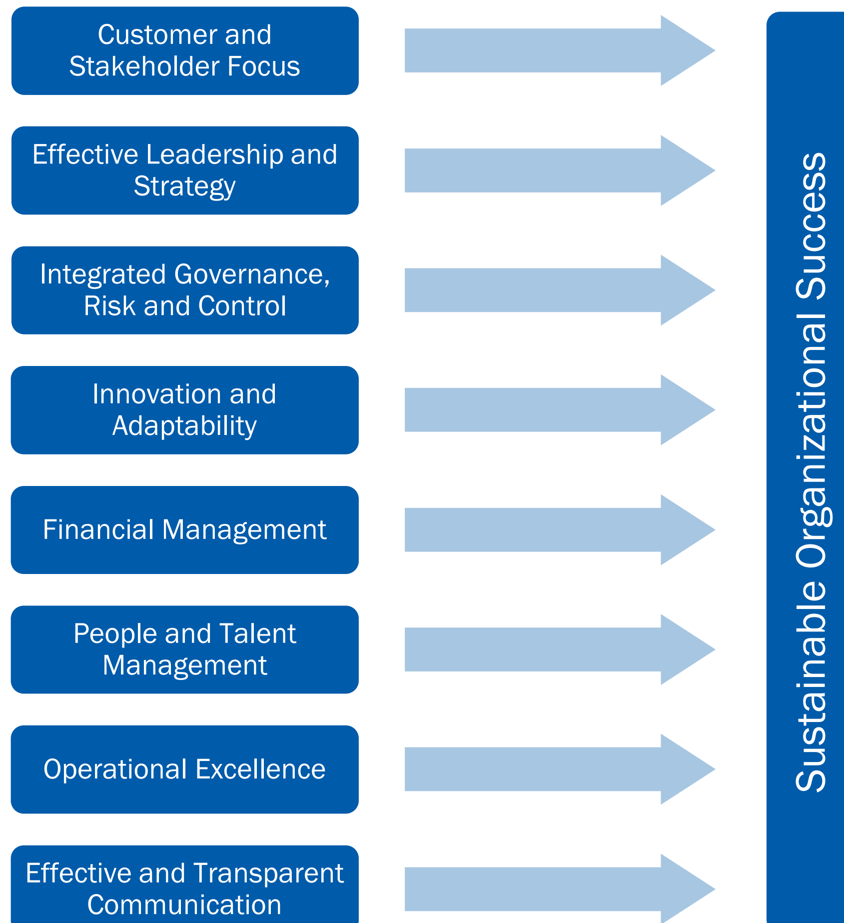
APPENDIX 1: CORE SECTOR-NEUTRAL ESG METRICS DEMANDED BY INVESTORS 25

APPENDIX 2: ADDITIONAL RESOURCES 27

Introduction

Responding to the widespread concern that investors typically do not sufficiently incorporate environmental, social, and governance (ESG) criteria into their investment decisions, this publication considers trends in investor demand for, and use of, ESG information. It alerts professional accountants in business to the core ESG metrics and indicators sought by investors and provides practical recommendations on the actions professional accountants need to take to streamline and improve the relevance and quality of their organization's internal and external business reporting.

High-quality business reporting is an important driver of investor, as well as wider stakeholder, confidence and trust in an organization. The challenge for professional accountants in their various roles in leadership, management, operations, management control, and stakeholder communications, is to be able to help organizations articulate their performance in both financial and non-financial terms, cutting across the eight drivers of sustainable success, as defined in *Competent and Versatile: How Professional Accountants in Business Drive Sustainable Organizational Success* and summarized in the diagram below.



Sustainable value creation and financial results ultimately flow from (a) performance across all eight drivers of sustainable success, as well as (b) how effectively ESG factors have been embedded into the way an organization is directed and managed. However, business reporting is typically overly focused on financial performance or, where organizations disclose sustainability or ESG-related information, it is often presented in a disconnected way, so that its relationship to strategy, operations, and financial performance is unclear. This is a key reason behind the proposed integrated reporting framework from the International Integrated Reporting Council (IIRC).[1]

This publication shows that ESG information is increasingly used by mainstream investors to understand an organization's key ESG factors and how they impact overall performance over a longer time horizon. There is still a long way to investor acceptance, but there has clearly been a noticeable shift by many investors toward using ESG information, as well as more proactively engaging the organizations they invest in and in encouraging use/disclosure of ESG information.

This trend is increasingly visible in various jurisdictions, including the US where, according to a recent survey by Ernst & Young, social and environmental resolutions comprised 40 percent of all shareholder proposals in 2011.[2] In terms of environmental risk, a recent study projects the monetary value of annual global environmental damage could reach $28.6 trillion in 2050. Many institutional investors are therefore considering their ownership rights from a broader perspective, and have an important role to play in encouraging companies and policy-makers to reduce negative impacts and account for external societal costs.[3]

Professional accountants need to be in a position to support their organizations in (a) meeting this increasing investor demand for ESG information, and (b) ensuring that both the organization and its investors receive a complete and relevant picture of organizational performance and impacts. They should be well placed to bring the discipline and application of accounting rigor to the collection, analysis, and reporting of ESG data, and support the incorporation of ESG factors into an organization's management processes and systems.

According to a survey by McKinsey, not all chief financial officers (CFOs) are convinced that ESG programs generate shareholder value.[4] However, their perspective converges with that of investors when it comes to understanding the financial value of ESG programs and factors, and measuring business opportunities as well as risks. The challenge for both investors and companies is how to communicate and interpret the value of ESG factors. The measurement and quantification of ESG factors is emerging, with companies and investors using various approaches and frameworks.

To help professional accountants focus on those measures of perceived importance to investors, this publication provides a sector-neutral list of core ESG key performance indicators (KPIs) that are typically used by many investors to evaluate ESG performance. This is supplemented by an examination of how investors might consider the financial implications and monetization of these factors, and recommendations for professional accountants.

---

[1] Please see Appendix 2 for more information on the International Integrated Reporting Council.

[2] Ernst & Young, *Climate Change and Sustainability: How Sustainability has Expanded the CFO's Role* (US, 2011), www.ey.com/Publication/vwLUAssets/Sustainability_extends_CFO_role/$FILE/CFOSustain.pdf.

[3] Trucost, *Universal Ownership: Why Environmental Externalities Matter to Institutional Investors* (UNEP Finance Initiative and Principles of Responsible Investing [PRI]: 2011), www.trucost.com/_uploads/publishedResearch/Universal_Owner_-_Final_report.pdf.

[4] "Valuing Corporate Social Responsibility," *McKinsey Quarterly* (February 2009), www.mckinseyquarterly.com/Valuing_corporate_social_responsibility_McKinsey_Global_Survey_Results_2309.

ESG—What's in a Name?

Various labels are given to what are essentially non-financial performance drivers of an organization, for example sustainability, corporate social responsibility (CSR), non-financial factors, and extra-financial factors. Defining sustainability and the business case is covered in the IFAC Sustainability Framework 2.0, which refers to the economic, environmental, and social aspects of organizational performance where:

- economic performance continues to include financial performance, but will increasingly reflect an organization's wider impact on the economy, which allows organizations and stakeholders to recognize that profitability, growth, and job creation lead to compensation and benefits for families, and to tax generation for governments;
- environmental performance relates to the natural resources consumed in delivering products and services and environmental impact; and
- social performance reflects an organization's impact on people and social issues, which include (a) health, skills, and motivation on the people side, (b) human relationships and partnerships on the social side, and (c) business conduct and ethics.

The term ESG has emerged, primarily in the investment community, to describe the environmental, social, and governance issues that investors are considering in the context of corporate behavior and performance, and which they might consider in their investment decisions. The *Financial Times* Lexicon describes ESG as "a generic term used in capital markets and used by investors to evaluate corporate behaviour and to determine the future financial performance of companies."[5]

[5] "ESG," Financial Times LEXICON, http://lexicon.ft.com/Term?term=ESG.

Investor Types and Perspectives

CLARIFYING INVESTOR TYPES AND RELATED STAKEHOLDERS

Investors can be institutional or individual (i.e., retail), and can also be referred to as asset owners. Investors have different investment strategies, time horizons, and objectives. Institutional investors, such as mutual funds, life insurance companies, and sovereign wealth, private equity, and pension funds, typically have longer investment time horizons than other investors because their liabilities to beneficiaries stretch over many years. However, institutional investors are also heterogeneous in terms of their investment style, time horizon, and investor base.

Fund or asset managers work on investors' behalf to implement an investing strategy, and to manage a portfolio and trading activities. Asset management methods also vary across countries. For example, many German asset owners manage their assets in-house rather than being invested externally with one or more asset managers, but relatively few do in the UK, where asset management is primarily outsourced to third parties.

Information analyzers and aggregators are closely related to investors, and include analysts, market research organizations, and credit rating agencies.

WHAT DRIVES INVESTORS TO BE SHORT-TERM IN THEIR PERSPECTIVES AND ACTIONS?

Short-term investment horizons arguably drive short-term decision making in companies, often to the detriment of sustainable value creation. This is evidenced by the chief executive officers (CEOs) surveyed in the joint American Institute of Certified Public Accountants and Chartered Institute of Management Accountants recent report, *Rebooting Business: Valuing the Human Dimension*, which highlights investor demands for short-term results and a focus on short-term rewards as specific challenges for companies.

Investment time horizons for investors are much analyzed and debated, and yet short termism continues to be hard to define. Fundamentally, investors will look to earn the rate of return they require for the risks they take,[6] and both long- and short-term investment strategies play a role in an efficient financial market.

However, a singular focus on maximizing short-term returns can undermine long-term economic value by (a) ignoring important risks and opportunities, and (b) driving short-term thinking within companies. This makes it more difficult to address the challenges of sustainable development, and can also act to the detriment of companies themselves. Research has shown that 80 percent of CFOs would sacrifice future economic value to satisfy investor expectations for short-term returns.[7]

Short termism among institutional investors is a complex challenge and sometimes associated with decreasing stock-holding periods. Theoretically, institutional investors, and particularly pension funds, invest for the longer term since the savings for pensions are available for investments over decades. However, this is not necessarily the case in reality. A study of leading European pension funds found that fund managers believed that the investment horizon of their pension fund should be 23 years, on average. In actual fact, however, the investments made are for significantly less time, averaging approximately six years.[8] Stock-

---

[6] Ellen Kelleher, "CFA Chief Questions 'Long-Term' Investing," *Financial Times*, July 25, 2011, www.ft.com.

[7] Ron Curran and Alice Chapple, *Overcoming the Barriers to Long-Term Thinking in Financial Markets, Forum of the Future* (Friends Provident Foundation and Forum for the Future: UK, 2011), www.forumforthefuture.org/sites/default/files/project/downloads/long-term-thinking-fpf-report-july-11.pdf.

[8] Axel Hesse, *Long-Term and Sustainable Pension Investments, A Study of Leading European Pension Funds*

holding periods, and their recent shortening, are not necessarily indicative of investor behavior in relation to ESG concerns. Institutional investors are not necessarily short-term oriented if they buy and sell the same shares on a regular basis.

Serious impediments to cultivating a long-term perspective may include the readiness of some investors to take short-term investment positions (and trading strategies for shares where stocks are held for a few days, hours, or minutes), driven at least in large part by rewarding asset managers for performance over a quarterly or annual basis. However, other challenges need to be considered.

The Organisation for Economic Co-operation and Development (OECD)'s report, *The Role of Institutional Shareholders in Promoting Good Corporate Governance*, investigates the role of institutional investors in promoting good corporate governance practices, including the incentives they face and how these impact the promotion of such outcomes.[9] It identifies a number of issues that might prevent institutional investors from promoting good corporate governance in companies in which they invest. For example, the report points out that a long-term shareholder is not necessarily a long-term *engaged* investor, and one that is intent on pursuing its stewardship role.

Additionally, although large institutional investors are often locked into long-term shareholding at most large companies for regulatory or other reasons, diversification and index investing is typical. Institutional investors should, therefore, have an incentive to encourage effective corporate governance in their large portfolio companies since it is the only way they have to earn greater returns. According to the OECD research, although some institutional investors already recognize this, a number of large ones are not acting in this manner.

This may be caused in part by financial incentives for institutional investment firms based on the volume of assets under management, instead of on the performance of the portfolio. It may also be due to limited cross-border engagement and voting. Investors do not typically vote on their foreign equity holdings (and foreign shareholders can make up approximately 30 percent of ownership in many jurisdictions). Engagement barriers include a lack of knowledge by institutional investors about foreign portfolio companies and actively managing a high number of portfolio companies. Furthermore, the investment chain has lengthened by outsourcing management to include investment managers and sub-advisors, providing further possibilities that incentives will not encourage institutional investors to take an interest in the corporate governance practices of investee companies.

There is also a danger of "invest and forget" associated with index investing, although some such institutional investors are activist in their approach and index tracking does not preclude company engagement on ESG factors. As the OECD report highlights, the real challenge of short termism may lie in the executive suites of companies and financial institutions with an emphasis on short payback periods.

(ASSET4 and German Federal Environmental Ministry: Switzerland, 2008), www.sd-m.de/files/Long-term_sustainable_Pension_Investments_Hesse_SD-M_Asset4.pdf.

[9] Organisation for Economic Co-operation and Development, *The Role of Institutional Shareholders in Promoting Good Corporate Governance* (Corporate Governance, OECD Publishing, 2011), www.oecd.org/document/53/0,3746,en_2649_37439_49075061_1_1_1_37439,00.html.

Current Demand from Investors for ESG Information and Disclosure

Two key challenges face policy-makers, organizations, and professional accountants regarding incorporation of ESG factors. First, there are differing views on whether ESG information is given credence by investors. Second, there is little consensus among investors and companies on key ESG investment criteria and how ESG information links to financial performance and long term sustainable success.

LEVEL OF INTEREST IN ESG FROM INVESTORS

Investor interest levels in ESG information vary, in part because of different investment philosophies, objectives, and incentives. In some cases, there is a belief among asset managers that there is a contradiction between the integration of ESG criteria into their investment decisions and their fiduciary responsibility (i.e., the legal responsibility for managing someone else's money) because of the debatable premise that ESG issues do not necessarily lead to superior risk-adjusted returns. The UN Environment Programme (UNEP) Finance Initiative has conducted work with the asset management constituency to dispel this view.[10]

In spite of this opinion, an increasing number of investors believe that ESG factors influence long-term sustainable organizational success. There is now evidence of an industry shift from niche socially responsible investing (SRI) to mainstream responsible investing, where mainstream, particularly institutional investors, are starting to use ESG information. The SRI market has also been growing in many countries. In the 12 months prior to June 2010, the number of SRI retail funds in Europe increased from 683 to 879, while assets under management rose 41 percent from €53 billion to €76 billion ($68 billion to $97 billion), according to an annual fund review by Vigeo, a corporate social responsibility ratings agency, and Morningstar, a provider of independent investment research.[11] In the US, the number of alternative investment funds incorporating ESG criteria has also increased to 375 funds (up from 346 funds in 2010).[12]

Research by the Harvard Business School indicates a strong level of interest among mainstream investors and information analyzers—on approximately 34 million occasions they accessed a list of environmental and social performance metrics over a two-quarter period using Bloomberg data terminals.[13] Additionally, other surveys provide evidence of a heightened interest from mainstream investors (see What Do Recent Surveys Reveal?). Of note is the 2011 analysis of signatory progress of the UN's Principles for Responsible Investment (PRI), an initiative of the UN Secretary-General's coordinated by the UNEP's Finance Initiative and the UN Global Compact, which found that 79 percent of asset owners and 95 percent of investment managers apply some level of ESG integration into internally managed (i.e., active) investments in developed market listed equities.[14] The first Principle of the UN's PRI—We will incorporate ESG issues into investment analysis and decision-making processes—encourages signatories to integrate the consideration of ESG issues into their research, analysis, portfolio construction, and other core investment practices.

---

10 Asset Management Working Group, UNEP Finance Initiative, *Fiduciary Responsibility, Legal and Practical Aspects of Integrating ESG Issues into Institutional Investment* (UNEP Finance Initiative: Switzerland, 2009) www.unepfi.org/fileadmin/documents/fiduciaryII.pdf.

11 Ruth Sullivan, "SRI Funds Popular in Europe," *Financial Times*, October 17, 2010, www.ft.com/intl/cms/s/0/b0a4161e-d885-11df-8e05-00144feabdc0.html#axzz1VrBOLn3C.

12 US SIF: The Forum for Sustainable and Responsible Investment, *Sustainability Trends in Alternative Investments in the US* (US, 2011), http://ussif.org/resources/pubs/.

13 Robert G. Eccles and George Serafeim, "Leading and Lagging Countries in Contributing to a Sustainable Society," *Harvard Business School Working Knowledge*, May 23, 2011, http://hbswk.hbs.edu/item/6716.html.

14 Principles for Responsible Investment, *5 Years of PRI: Report on Progress 2011* (UNEP Finance Initiative and United Nations Global Compact, 2011), www.unpri.org/publications/2011_report_on_progress_low_res.pdf.

Investors incorporating ESG analysis have also been shown to outperform their peers. A Trucost and RLP Capital study compared the carbon and financial performance of the largest actively managed, traditional, and responsible US mutual funds (i.e., those incorporating both financial and ESG analysis to identify companies with solid financial prospects that also demonstrate positive track records with regard to ESG). Findings showed that funds incorporating ESG analysis in their investment decision making outperformed traditional funds over one- and three-year periods. These findings are supported by a separate report by Harvard Business School and the London School of Business that shows "high" sustainability companies significantly outperform similar "low" sustainability companies over the long-term in both stock market and accounting performance.[15] However, this research also shows that sustainability related practices take time to implement and clear outperformance is only visible after three years.

Although there is research that shows that the historical performance of corporate responsibility or ethical indexes does not necessarily lead to superior long-term returns, the traditional asset management business is moving into responsible investing even while unsure of its impact on fund returns. This is because these funds can generate their revenue predominantly from fees on assets under management.[16] Furthermore, innovative investment approaches, such as Goldman Sachs' GS SUSTAIN, which identifies those companies best positioned to sustain competitive advantage and superior returns over a three- to five-year period,[17] use more than ESG criteria alone when making investment choices.

[15] Robert G. Eccles, Ioannis Ioannou, and George Serafeim, "The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance," *Harvard Business School Working Knowledge,* November 14, 2011, http://hbswk.hbs.edu/item/6865.html.

[16] Vinay Nair, *Mainstream? The Opportunity and Obstacles for Sustainable and Responsible Investment,* (swissHEDGE: US, 2010), www.unpri.org/academic10/Nair,%20Vinay_investors_view_.pdf.

[17] Goldman Sachs, *GS SUSTAIN: Challenges in ESG Disclosure and Consistency* (US, 2009), www.unpri.org/files/GS_SUSTAIN__Challenges_in_ESG_disclosure_and_consistency.pdf.

WHAT DO RECENT INVESTOR SURVEYS REVEAL?

Recent surveys provide a useful indication of current trends in relation to the use of ESG information that, to some extent, supports the findings of the Harvard Business School study.

- Among the respondents to a global investor survey in 2011, most participating investors (87 percent of asset managers and 98 percent of asset owners) view climate change issues as a material investment risk/opportunity across their organization's entire investment portfolio. Earlier research published by Mercer showed that approximately 10 percent of global investment managers have begun to integrate ESG issues into their investment processes.[18] It appears that climate change is increasingly becoming a strategic issue. This is also supported by the finding that responsibility and accountability for climate change now resides at the board level or equivalent, rather than the SRI team, for the majority of investors.
- In 2010, in partnership with Eurosif (European Sustainable Investment Forum), Novethic (a research center on socially responsible investment and corporate social responsibility) surveyed 251 European investors about how they perceive the integration of ESG criteria into asset management. Eighty-four percent of respondents believed that integrating ESG criteria maximizes beneficiaries' long-term interest.[19] Are institutional investors ready to reduce their emphasis on short-term financial performance? To answer this question, respondents were asked to define a long-term investor. Their answers show the majority (54 percent) believes a long-term investor focuses on building long-term performance through short- and mid-term performance. Twenty-eight percent of respondents indicated they sacrifice some short-term performance to better cope with long-term risks. Eighteen percent claim to be ready to accept lower returns in favor of a more sustainable development. The survey also showed that viewpoints vary significantly from one country to another.
- Investors show more awareness of ESG policies and products than sell-side analysts do. Fund managers seem to use extra-financial or non-financial information to a lesser extent than buy-side analysts, while hedge fund managers focus less on ESG issues than other investor types do. Investors with "passive" index-tracking portfolios do not attach high importance to extra-financial information.[20] Passive investors tend to place significantly more importance on carbon prices (particularly when they are greater than $100 per tonne) and availability of subsidies for energy use than an SRI investor does.[21]

---

[18] Institutional Investors Group on Climate Change, Investor Network on Climate Risk, Investor Group on Climate Change, and Mercer, Global I*nvestor Survey on Climate Change: Annual Report on Actions and Progress 2010 (2010),* www.ceres.org/resources/reports/2010-global-investor-survey-on-climate-change-1.

[19] Novethic, European Asset Ow*ners: ESG Perceptions and Integration Practices, December 2010 (France, 2010),* www.novethic.com/novethic/v3_uk/upload/ESG_Survey_2010.pdf.

[20] William Jaworski, Use of Extra-Financial Information by Research Analysts and Inve*stment Managers, March 2007 (European Centre for Corporate Engagement: Netherlands,* 2007), www.gmiratings.com/noteworthy/ECCE_Survey_March_2007.pdf.

[21] Matthew Haigh and Matthew A. Shapiro, Financial Institutions: Taking Greenhouse Gases I*nto Account (Climate Disclosure Standards Board: UK, 2011),* www.cdsb.net/file/56/financial-institutions---taking-greenhouse-gas-emissions-into-account-cdsb-2011.pdf.

Investor Approaches to Dealing with ESG Factors

Investors typically have proprietary approaches for assessing companies, although there are similarities across various investment approaches. The Novethic survey of European Asset Owners, mentioned above, found that more than 90 percent of the asset owners surveyed believe that ESG screening means "carefully monitoring companies' sustainable development practices," or "selecting issuers based on ESG criteria." There are four generic investment approaches.

- **Negative ESG screening**—excluding from an investment portfolio specific industries or sectors, such as alcohol, tobacco, gambling, nuclear, military, or other controversial areas.
- **Positive ESG screening**—also known as "best-in-sector" or "best-in-class" investing, whereby the scope of the investable universe is restricted to highly rated ESG companies (see ESG ratings for challenges with this approach).
- **Engagement**—involving a dialogue between a shareholder and a company with the aim of improving the company's value through greater incorporation of ESG factors. Engagement is most relevant for pension funds and other long-term shareholders as a means to improve ESG outcomes and, therefore, investment returns, although levels of engagement can vary in intensity. According to the 2011 analysis of the UN's PRI, three in four signatories have been involved in engagement activities, with a majority of asset owners asking either their investment managers or specialist engagement service providers to undertake engagement on their behalf.
- **ESG integration**—integrating specific ESG information and criteria into financial valuations associated with a company.

ESG RATINGS

A variety of agencies and rating services exist, each using proprietary methodology. Therefore, a company can be rated very differently depending on the provider of the rating. Key areas of discrepancy between methodologies include (a) the treatment of the resources sector, (b) the treatment of the financial services sector, (c) incorporation of ethical information, (d) weighting given to material versus non-material issues, (e) method for standardization of data and, in particular, (f) treatment of company non-disclosure of information.

Investors are increasingly migrating away from relying on positive screening, although this is by no means universal (e.g., the Novethic survey shows disparity between northern European countries that more strongly emphasize shareholder engagement, and southern European countries that emphasize ESG screening).

Companies also need to consider their engagement with ESG research and rating organizations, particularly how they prioritize information requests they will respond to with respect to specific ESG-

related information. The McKinsey survey found that few CFOs or investment professionals found value in external rating, ranking, or reporting standards or guidelines to assess the effects of ESG programs. Criticisms of ratings are that they compete on data rather than on analysis, and omit core business issues, such as risk and financial performance.[22]

For additional information:

"Rating the Rating Surveys," an *Inside Investor Relations* article containing tips on sifting through sustainability raters.

The Global Initiative for Sustainability Ratings is a global, non-commercial, multi-stakeholder initiative to develop a generally accepted ratings framework for assessing the sustainability performance of companies.

Footnote[22]

CHALLENGES TO MAINSTREAMING ESG WITHIN THE INVESTOR COMMUNITY

Despite a trend toward mainstreaming ESG within the investor community, there are challenges to wide-scale adoption of ESG criteria. Many professional accountants will engage with investors who never ask for information related to ESG factors. The European Academy for Business in Society (EABIS)-funded research project, which explored how the ESG performance of companies might impact the drivers of business success and how companies explain these linkages to investors, found a number of obstacles to investors and companies mainstreaming ESG.

- **Investors' mindsets, decision techniques, and investment time horizons:** Investors are inherently inclined toward both quantification and short termism. Furthermore, where data are collected by companies on ESG issues, they are often undermined by inconsistencies and insufficiencies arising mainly from the differences of ESG data in terms of actors, industries, regions, and countries.
- **Investors' perceptions of ESG issues:** According to investors, ESG issues present a high degree of complexity, which makes them very difficult to articulate, assess, and integrate into investment decisions. This complexity is particularly tied to the challenge involved in understanding the boundaries of ESG issues. The expansionary nature of ESG issues is also a source of concern for many investors. The issues are constantly evolving and, as such, are difficult to pin down. Some investors argue that the quest to unpack and address these complexities often leads to information overload.[23]

The result of these obstacles is that many investors marginalize ESG issues so that they are treated with a "tick box" or compliance mentality rather than with a mindset that fosters the formal appraisal and measurement of material ESG factors. This also means that they typically do not use their shareholder voting rights to deliver their responsible investing criteria.

[22] Leslie Guevarra, "6 Tips for Making Sustainability Ratings More Meaningful," GreenBiz.com, July 18, 2011, www.greenbiz.com/news/2011/07/18/6-tips-making-sustainability-ratings-more-meaningful.

[23] EABIS, *Sustainable Value, EABIS Research Project September 2009: Corporate Responsibility, Market Valuation and Measuring the Financial and Non-Financial Performance of the Firm* (Belgium, 2009), http://investorvalue.org/docs/EabisProjectFinal.pdf.

What Specific ESG Performance Information and Indicators Do Investors Seek?

Although data providers, ratings agencies, and research firms provide ESG information and analysis, companies themselves are the primary source of useful insights and disclosure. Active engagement by investors and other stakeholders with an organization can bring more direct understanding of its ESG issues and performance. The metrics that respondents of the McKinsey survey, CFOs and investment professionals, would find most helpful for understanding the financial value of ESG programs are those that (a) quantify their financial impact, (b) measure business opportunities as well as risks, and (c) are transparent about their methodology.

The 2010 UN Global Compact–Accenture CEO Study, *A New Era of Sustainability*, found that 86 percent of CEOs see accurate valuation by investors of sustainability in long-term investments as important in reaching a tipping point in sustainability.[24] An accurate valuation and understanding of the impact of ESG factors will depend on high-quality disclosures and analysis, as well as a dialogue with investors to (a) educate them on what is material, particularly in terms of how environmental, social, and financial performance relate to each other and contribute to sustainable value creation, and (b) encourage them to consider those factors that affect cash flows and line items in the financial statements. According to the study, which also involved conversations with the investor community, investors feel that companies can take two principal actions:

- Track the impact of sustainability on core metrics (such as revenue growth, cost reduction, risk management, and reputation).
- Become more proactive in shaping the attitudes and mindsets of investors. This will involve determining the nature of investor communication that is needed, including timing, presentation, and scope.

ESG KPIs USED BY INSTITUTIONAL INVESTORS

Although investors typically have proprietary approaches and models for assessing companies, many seem to be gravitating to a number of ESG factors, related KPIs, and disclosures. Appendix 1 includes a core set of non-sector-specific generic ESG indicators and measures that interested investors primarily look for. Some of the indicators are also covered by the Global Reporting Initiative (GRI)'s Sustainability Reporting Guidelines (indicated by a related GRI cross-reference), which, in the environmental and social areas, typically provides greater coverage than the KPIs listed in Appendix 1. These Guidelines are the most widely used globally (see Appendix 2 for additional information on GRI). The listed KPIs have been compiled on the basis of an informal review of a selection of investment research approaches and the emphasis of investors on those measures that may impact financial performance. The importance of ESG performance drivers and KPIs to corporate strategy and sustainable value creation will vary by industry sector.

Some investor groups have produced their own guidelines, for example, the *ESG Reporting Guide for Australian Companies, Building the Foundation for Meaningful Reporting*, prepared jointly by the Australian Council of Superannuation Investors and the UK Financial Services Council to highlight the minimum information and reasonable data requirements that are needed for their member organizations to successfully price, analyze, and manage ESG investment risks.[25] This guide aims to provide common ground between institutional investors and the companies in which they invest in

[24] Peter Lacy et al., *A New Era of Sustainability: UN Global Compact-Accenture CEO Study 2010* (New York, 2010), http://unglobalcompact.org/docs/news_events/8.1/UNGC_Accenture_CEO_Study_2010.pdf.

[25] Australian Council of Super Investors and the Financial Services Council, *ESG Reporting Guide for Australian Companies: Building the Foundation for Meaningful Reporting*, *First Edition June 2011* (Australia, 2011), www.fsc.org.au/downloads/file/policyresearch/FSC0024ReportGuide_InteralFA1Rlores.pdf.

defining the ways ESG factors influence their shared goals to achieve sustainable growth and prosperity.

LEADING INDICATORS USED BY INVESTORS

The indicators in Appendix 1 are primarily lagging (i.e., results based) indicators of performance. Investors may also be interested in tracking leading indicators of performance. Focusing on lagging indicators does not necessarily provide an indication of whether an organization is addressing its material needs in relation to ESG, or that an organization is working to achieve desired outcomes, or to avoid risks. Institutional investors will often use indicators of future performance to assess management credibility either through active engagement with the management of companies, or from effective business reporting. Key performance areas can include how senior executives guide the organization in terms of vision and leadership, and how it is addressing sustainability and long-term opportunities and risks as part of its overall strategy, key action plans, operations, people management, and supply chain.

HOW INVESTORS AND COMPANIES MIGHT CONSIDER THE FINANCIAL IMPLICATIONS OF ESG FACTORS

A challenge to the incorporation of ESG factors, is that there is little consensus on how best to link these factors to financial performance, although some investors and companies are now on a journey toward better understanding the ESG impact on financial performance and valuations. Their focus is typically on identifying material ESG factors and performance indicators related to the drivers of competitive advantage and sustainable value creation of a sector, or individual organization that will ultimately drive financial performance. For example, in the oil and gas sector, key ESG focus areas typically include strategic risks, such as operations in high risk areas and climate change; emissions; health and safety; and community relations.

Linking ESG factors and KPIs to financial drivers of performance can be done in various ways, with many investors integrating ESG information into their traditional financial analysis. Investors can assess financial outcomes of various ESG factors in terms of changes to cash flows and earnings impact, cost of capital, and asset values. Linking environmental factors to financial performance in terms of cash flow and earnings impact seems to be the most developed area. Using carbon dioxide as an example, investors may track measures such as carbon cost as a percentage of revenue; carbon cost as a percentage of earnings before interest, taxes, depreciation, and amortization (EBITDA); financial impact of carbon dioxide allowance trading; and impact of compliance costs on cash flows and earnings.

Investors are also increasingly incorporating human capital (social) information into financial analysis where reliable data can be accessed (see The Bottom-Line Impact of Employee Turnover).

THE BOTTOM-LINE IMPACT OF EMPLOYEE TURNOVER

To measure the financial impact of employee turnover rates (also referred to as churn), ASSET4, an ESG information provider, examined the results of 15 studies on the estimated costs of replacing employees to determine a factor that can be combined with the average employee and benefit packages across sectors. By multiplying the resulting values with the actual reported turnover rates of companies and then analyzing the final values in relation to EBITDA, it becomes possible to realize the bottom-line impact of employee turnover rate on company performance in different sectors. The financial impact of employee turnover rates can be as high as 16 percent for the consumer discretionary sector, 13 percent for industrials, and 11 percent for health care.

The Bloomberg ESG Valuation Tool that is being developed as part of Bloomberg's ESG information service enables users to assess ESG-related cost impacts on a company's EBIT (earnings before interest and taxes) performance and share price valuation. Together with the ESG data service, users can quantify profit and loss risks from ESG efficiency on profitability, and compare relative efficiency and impacts across companies. As well as providing absolute figures, data is normalized to allow companies to be more easily compared, such as providing intensity measures of various ESG factors per sales, EBITDA, employee, and assets.

ESG issues can be capitalized by converting ESG-related flows into capital flows by applying pricing factors, such as carbon and oil prices, waste treatment costs, water, and paper costs. Certainty in pricing can be driven by government action, as is the case in Australia where the Clean Energy Legislative Package, passed in November 2011, established a fixed carbon tax that will apply to approximately 500 companies. This policy approach enables investors to price carbon in their portfolios, therefore making carbon liability a visible exposure and risk.

Some companies are also proactively improving their approaches to valuation and, therefore, improving disclosure to investors. For example, PUMA, a sport life style company, developed with PwC and Trucost an Environmental Profit and Loss (EP&L) Statement 2011.[26] PUMA's methodology quantifies the tonnes of greenhouse gas (GHG) emissions and cubic meters of water consumed in their business and supply chain operations, and then apply values to account for the associated economic impacts. The standard profit and loss applies a value of €66/tonnes of CO_2; the average water value applied in the EP&L is €0.81 per cubic meter. This approach helps to reveal the company's direct ecological impact of its operations. By putting a monetary value on the environmental impacts, PUMA can better determine the best options for mitigating its footprint of its operations and supply chain, as well as preparing for potential future legislation.

[26] "PUMA Announces Results of Unprecedented Environmental Profit and Loss," PUMA, http://safe.puma.com/us/en/2011/05/puma-announces-results-of-unprecedented-environmental-profit-loss/.

Implications of Managing and Reporting ESG Performance for the Profession

The accountancy profession and professional accountants have a key role to play in (a) helping their companies and investors to appreciate the significance of ESG performance data and the potential or actual impact on business performance, and (b) improving the robustness and accuracy of data, metrics, and analysis, and subsequent disclosures.

The following recommendations are aimed at helping professional accountants to enhance the quality of internal and external business reporting so that it is more useful and relevant for investors.

ENGAGE INVESTORS EFFECTIVELY TO DETERMINE THEIR INFORMATION NEEDS TO BETTER COMMUNICATE PERFORMANCE

Professional accountants should work with their organizations to implement a structured and systematic approach to engaging investors to determine their ESG information needs. This enables effective communication of an organization's ESG performance, and ultimately its ability to create and sustain value over time, and what this means for current and potential investors.

Engaging investors and other stakeholders is the first step in determining their information needs and appetite for ESG data, as well as facilitating their understanding and appreciation of how ESG factors and performance will help ensure that the organization remains competitive and creates sustainable value. Investor as well as wider stakeholder engagement is also an important basis of ensuring that disclosures are not ultimately viewed as only being management's determination of material information.

CFOs and finance directors, in particular, often have investor relations as a part of their job description. ESG and sustainability are key areas in which their role is expanding. Their investor relations roles increasingly require them to articulate how ESG fits into the investment proposition, and understanding the importance and most effective ways of communicating with investors about how the organization manages sustainability issues.

Even where investors do not directly analyze the impact of ESG factors on investment value drivers, they often use such factors to assess management credibility, which forms a significant intangible driver of company value.

Transparent investor engagement and dialogue is also likely to be important because of its impact on the types of investors an organization might attract. The kinds of investors who own the company's shares can ultimately end up affecting its decision making and value. Companies that provide earnings guidance tend to attract disproportionately large numbers of momentum investors (i.e., those with a great deal of small positions and very high turnover)—and the stock prices of such companies tend to experience larger-than-average volatility. Therefore, companies appear to have the ability to attract different kinds of investors through their disclosure policies. According to Don Chew, editor of the *Journal of Applied Corporate Finance*, "if you hold up quarterly earnings as your main goal, you will attract investors who care mainly about the next quarter's earnings."[27]

Some people believe and advocate that earnings guidance promotes short-term thinking, and does little or nothing to increase the company's long-term value.[28] According to the CFO of Siemens, "volatility benefits short-term shareholders."[29] Therefore, a number of companies, such as GlaxoSmithKline, Unilever, and General Electric, have ceased

---

27 Scott Bauguess et al., "Drexel University Center for Corporate Governance Roundtable on Risk Management, Corporate Governance, and the Search for Long-term Investors," *Journal of Applied Corporate Finance*, Fall 2010, www.morganstanley.com/views/jacf/archive/ab1d1eee-2592-11e0-bf0c-7fbcb3d7fc78.html.

28 Deloitte, *CFO Insights: The Earnings Guidance Debate* (2009), www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/US%20CFO%20Program_Earnings%20Guidance_0709.pdf.

29 David M. Katz, "Volatility Benefits Short-Term Shareholders," CFO.com, July 22, 2011, www.cfo.com/article.cfm/14591163/1.

to provide earnings guidance.[30] In many cases, such a move is made to refocus the company on a long-term and customer-focused perspective, and to determine materiality in favor of long-term owners rather than for short-term traders. For example, Paul Polman, CEO of Unilever, stated, "I discovered a long time ago that if I focus on doing the right thing for the long term to improve the lives of consumers and customers all over the world, the business results will come... I'm not driven, and I don't drive this business model, by driving shareholder value. I drive this business model by focusing on the consumer and customer in a responsible way, and I know that shareholder value can come."[31]

INCORPORATE ESG FACTORS AND PERFORMANCE INFORMATION INTO GOVERNANCE AND ACCOUNTABILITY ARRANGEMENTS TO IMPROVE INFORMATION AND DISCLOSURE QUALITY

Professional accountants should work with their organizations to implement governance processes that help embed ESG factors in management and reporting processes. This will lead to reliable and high-quality non-financial (as well as financial) information that is needed by internal decision makers, as well as expected by investors.

The IFAC Sustainability Framework 2.0 refers to the need for managerial and operational structures to ensure accountability and ownership for sustainability (or ESG) factors and programs. Governance of economic, environmental, and social performance should be a key area for consideration by professional accountants, particularly to (a) ensure the link between vision, leadership, strategy, key action plans, and operational performance, and (b) help enhance the reliability and quality of non-financial performance and risk information, which, as mentioned above, tends to be a concern of investors. In many organizations, financial information and disclosures are subjected to a greater degree of oversight.

Explaining the link between strategy and ESG factors in terms of mitigating risks and seizing opportunities becomes easier where ESG performance data becomes more trusted by stakeholders and focused on its potential or actual impact on business performance.

Professional accountants should therefore consider how governance processes can help to improve confidence in the understanding of ESG factors, how they are embedded in the organization, and the resulting impact on performance. Key action points might involve the following:

- Recognizing and selling the importance of ESG factors in relation to business performance to the governing body, and perhaps the CEO and/or chairman. The governing body needs to collectively recognize the importance of significant ESG factors if it is to integrate these into the culture and decision making throughout the organization.
- Ensuring systems and processes of governance, risk management, and internal control cover material ESG risks and performance information.

A governing body can approach the accountability and oversight arrangements for ESG issues in various ways. In some contexts, it might involve establishing a separate sub-committee of the board, or ensuring that an existing committee incorporates accountability for sustainability and ESG within its remit. Where there is no stand-alone risk or sustainability committee, the audit committee could also be responsible for providing oversight to the identification, management, and reporting on significant ESG risks and related internal controls, as well as ESG performance information. The governing body and audit committee might also encourage management to align systems and processes used to provide information for internal decision making to those supporting external business reporting.

---

[30] Andrew Hill, "Can't Tell, Won't Tell: Unilever and GSK Set the Tone," *Financial Times*, February 6, 2009, www.ft.com.

[31] Stefan Stern, "Outsider in a Hurry to Shake Up Unilever," *Financial Times*, April 4, 2010, www.ft.com/cms/s/0/fa865f42-3ff3-11df-8d23-00144feabdc0.html.

LINK FINANCIAL AND NON-FINANCIAL PERFORMANCE AND OUTCOMES TO IMPROVE UNDERSTANDING OF SUSTAINABLE VALUE CREATION

Professional accountants should work with their organizations to enhance understanding of the link between financial and non-financial drivers of performance and value. Integrated reporting will involve professional accountants being able to clearly present the linkage between financial performance and the organization's use of, and impact on, the significant resources and relationships upon which it depends to create sustainable value.

Given that investors are increasingly taking into account ESG and other non-financial drivers of performance and value, it will be important to show which drivers are key determinants of market value and sustainable value creation. To help connect financial and non-financial performance, it can be useful to consider performance within the context of a framework comprising the potential key financial and non-financial performance and value drivers.

Professional accountants can support their organizations by using various management and reporting frameworks (see Appendix 2) to identify which ESG performance drivers are material to corporate strategy and contribute to sustainable value creation. Of key importance to both companies and investors is how these ESG factors relate to financial drivers of performance and, ultimately, market value, such as revenue growth, operational efficiency, brand equity, cost of capital, and risk factors (see the EABIS Framework for a method of mapping ESG factors to financial impacts[32]).

For example, in banking, the most material ESG performance drivers and impacts might include customer and employee satisfaction, reputation, key competencies and talent management, executive/ manager remuneration, sovereign debt-related affairs, regulatory uncertainties (e.g., International Regulatory Framework for Banks [Basel III]), and scope 3 emissions relating to investments.[33] These factors potentially impact financial performance, such as net interest income, asset and liability margins, capital ratios, bad debts, non-performing loans, and liquidity.

Effective integrated reporting should take the engagement between investors and companies to a next level so that the constituent elements of market value are better understood (thereby bridging the gap between accounting and market value), but also ensuring that this value creation is sustainable. This is the aim of the widely supported global initiative on integrated reporting being led by the IIRC (see Appendix 2). Integrated reporting brings together material information about an organization's strategy, governance, performance, and prospects in a way that reflects the commercial, social, and environmental context within which it operates. It helps to provide a clear and concise representation of how an organization demonstrates stewardship, and how it creates and sustains value.[34] An integrated reporting approach also helps to align external reporting with information that management uses for decision making, including the use of both leading and lagging indicators of performance. This will, hopefully, better enable the users of business reports to better assess what is driving sustainable organizational success.

[32] "Valuing non-financial performance: A European framework for company and investory dialogue," European Academy for Business in Society, http://investorvalue.org/framework.htm.

[33] Greenhouse Gas Protocol, *Corporate Value Chain (Scope 3) Accounting and Reporting Standard* (Switzerland and US, 2011), www.ghgprotocol.org/standards/scope-3-standard.

[34] International Integrated Reporting Council, *Towards Integrated Reporting: Communicating Value in the 21st Century* (UK, 2011), www.theiirc.org/the-integrated-reporting-discussion-paper/.

Integrated reporting offers an opportunity to be seen as a best-in-class reporter. Being recognized as a high-quality reporter can enhance the organization's reputation and foster greater trust with its stakeholders. However, integrated reporting can take time to achieve, and for many organizations will involve starting with the basics of establishing the necessary supporting processes and systems. Developing the process of preparing ESG information can lead to the introduction and subsequent maturity of governance, managerial, and operational activities that support the integration of ESG factors in the way an organization makes decisions.

ENSURE MATERIAL, TIMELY, CONSISTENT, AND COMPARABLE INFORMATION TO IMPROVE THE USEFULNESS OF REPORTING AND GREATER TRANSPARENCY

Professional accountants should work with their organizations to ensure that ESG disclosures meet investor needs by being material, timely, consistent, and comparable to improve usefulness of reporting.

Investors typically require a narrower and more focused set of ESG disclosures than other stakeholders, which are consistently reported over time, comparable to the disclosures of other organizations, synchronized to the timing of financial disclosures, and forward looking. Organizations too often disclose information that is not used, which leads to unnecessary costs without satisfying intended audiences. There are often vast disclosures on immaterial issues, particularly with ESG or sustainability reporting. Increasing the relevance of reported information involves applying materiality in a way that it is a key constraining characteristic to ensure avoidance of unnecessary clutter and cost burdens in providing decision-useful information to users. At the same time, the more long-term the view of the risks and opportunities that an organization faces, and the more stakeholders an organization engages with, the wider the net of material issues becomes.

Preparers and report issuers need to be able to clearly define and apply materiality concepts and thresholds to ensure that an organization's ESG disclosures are relevant to the intended users. Materiality can be determined in part by engagement and dialogue with investors, but needs to extend to other stakeholders. Investors can be interested in the issues that arise from wider stakeholder engagement and how engagement has influenced the organization's strategy and its reporting. A key challenge for the professional accountant is distinguishing materiality thresholds that are applied to wider sustainability or ESG reporting (separate from the mainstream annual or integrated report) from the thresholds used for financial reporting information focused on investors.

Some KPIs and measures will have greater importance depending on the sector in which an organization is operating (hence GRI's Sector Supplements that capture issues essential to sustainability reporting in a specific sector[35]). Key issues for determining materiality in terms of relevant ESG factors, indicators, and metrics include:

- report on indicators, preferably a small number, that are materially relevant to the organization and its strategy, goals, and targets, and, where possible, explain the link between indicators and strategic and financial (e.g., cash flows) outcomes;
- ensure indicators include external benchmarks, such as industry norms and standards; and
- report time series data with adequate historical data to show trends and progress (given that ESG factors can evolve over long periods of time).

Approaches to applying materiality to sustainability and integrated reporting are considered further in the [IFAC Sustainability Framework 2.0](#).

[35] Global Reporting Initiative, *Sector Guidance* (Amsterdam, 2008), www.globalreporting.org/reporting/sector-guidance/Pages/default.aspx.

Relevance will also be enhanced with the improved presentation of information. For example, disclosing how much has been spent on an activity (such as investments in emissions abatement or employee training) is only useful if the impact of these investments has been clearly articulated. Leading performance indicators are usually accompanied by greater narrative explanation, because they need to indicate the actions that could lead to improved results and outcomes. A narrative might be needed to explain, for example, how a talent management and training program is leading to greater innovation and therefore a "greener" product line and new revenue-generating opportunities.

Investors can also be concerned about timeliness of disclosure. Separate sustainability reports are typically released after annual reports and financial statements. However, communication of ESG KPIs (targets and achievements) and metrics might be more usefully synchronized with financial reporting periods and, to the extent possible, included in the annual reports of the organization where they are relevant to understanding the organization's performance and financial position. An integrated reporting mindset and approach will help companies to improve the timeliness as well as the usefulness of their disclosures.

Consistency and comparability of reported information is a key goal for investors. The use of widely accepted reporting and indicator frameworks and guidelines can help companies develop reporting processes and improve the comparability of disclosures. Professional accountants need to be familiar with various reporting and measurement frameworks and methodologies, particularly the GRI Sustainability Reporting Framework and Guidelines. Companies can explain to investors any standards or guidelines that they have applied in preparing KPIs and disclosures and, where appropriate, provide definitions and assumptions used in the calculation of metrics where an external standard does not exist or has not been applied.

BRING TOGETHER DATA THAT MAY BE DISPERSED IN DIFFERENT PARTS OF THE ORGANIZATION OR ITS SUPPLY CHAIN TO SUPPORT INTERNAL AND EXTERNAL DECISION MAKING

Professional accountants should work with their organizations to connect processes, systems, and data across various organizational functions, and within the extended supply chain. From a reporting perspective, greater collaboration and coordination between the finance and accounting functions, specialist sustainability, or corporate responsibility, as well as operational teams and suppliers, will be needed to help break down silos in the way information is managed and reported.

Breaking down functional silos or barriers will be necessary to deliver effective integrated management and reporting of ESG performance. The quality of integrated reporting in particular hinges on (a) the level of integration of ESG factors into the management and operational processes within the organization and (b) the collection, storage, and analysis of ESG information. At a reporting level, various parts of the organization may need to interact more closely, especially the finance function and those involved in sustainability or corporate responsibility teams, as well as others involved in preparing disclosures, reports, and communications.

This greater collaboration and coordination within an organization can help to ensure that sustainability and financial reporting processes are better aligned, and that there is a better connection between reporting elements. For example, in addition to reporting greenhouse gas emissions, organizations might also find it useful to report on the climate change risks it is managing, and how these could develop and affect short- and long-term performance. Collaboration and coordination might even extend to preparing external reports, such as the joint editorial team approach used by Novo Nordisk to prepare their annual report, which include ESG disclosures. The editorial team involves

representatives from finance, investor relations, legal, and operations.[36]

Automated processes can help to improve timeliness and accuracy. This might involve moving beyond spreadsheet-based processes for gathering and reporting data. For example, in relation to carbon emissions data, for relatively simple operations, spreadsheets offer considerable versatility by allowing individuals to readily sort and analyze collected information. However, for larger organizations, where data is derived from multiple sources, and multiple users require access, a more sophisticated approach might be needed. This might involve carbon management software, or adding elements to existing business warehousing information architecture that also allow data feeds from multiple sources (e.g., from external energy providers or from internal sources covering staff travel and purchasing, or the supply chain).

---

[36] Chartered Institute of Management Accountants and Accenture, *Sustainability Performance Management: How CFOs Can Unlock Value* (UK, 2011), www.cimaglobal.com/Thought-leadership/Research-topics/Sustainability/Sustainability-performance-management-how-CFOs-can-unlock-value/.

Appendix 1: Core Sector-Neutral ESG Metrics Demanded by Investors

Measurement Area	Typical Generic Metrics and Performance Indicators Investors Look For	Related GRI Indicators
Environmental		
Climate change Greenhouse Gas (GHG) emissions	• Total direct and indirect GHG emissions (scope 1 and 2) in tonnes/ kilograms of CO_2 broken down by type of energy source. This could also cover a percentage of operations included • Total other direct GHG emissions (scope 3), including emissions from business travel by employees and supply chain • Carbon price (or shadow) • *Example intensity measure*[37]*:* Tonnes/kilograms CO_2 as percent of turnover	EN16, EN17
Waste and waste recycling ratio	• Total waste • Type of waste (hazardous versus non-hazardous) produced by product and volume • Percent of waste reused in the manufacturing process • *Example intensity measure:* Waste per person or square foot/ meter and percentage recycled, or total waste per sales	EN22
Water	• Amount of water consumed (e.g., cubic meters) by quality/source and percent water usage from recycled sources • *Example intensity measure:* Water consumption per unit of sales	EN8, EN9, EN10
Fines/provisions	• Monetary fines and non-monetary environmental sanctions • Environmental provisions as reported on the balance sheet	EN28
Energy efficiency/renewable energy use	• Total amount of energy used by the organization (e.g., MWh, KWh or Joules) • Amount of energy consumed that was generated from a renewable energy source • Financial impact of emission reduction initiatives • Energy saved due to conservation and initiatives to reduce energy consumption • Capex expenditure in "green" technology or to facilitate more sustainable practices • *Example intensity measure:* Energy use per square foot/meter, or per sales	EN3, EN4, EN5, EN6, EN7
Biodiversity	• Location/size of land owned, leased, managed in, or adjacent to, protected areas and areas of high biodiversity (such as trees and vegetation as well as wildlife and endangered species) value	EN11, EN12, EN 13, EN14, EN15
Social		
Workplace health and safety	• Workforce accidents (total) and fatalities • Lost time from accidents (number of hours or days) • *Example intensity measure*: Lost time injury frequency rate: i.e., lost time injuries per million man-hours (or total recordable injury frequency rate)	LA7

[37] Disclosure of environmental and social indicators can be improved by disclosing both absolute values and intensity measures. For example, energy efficiency can be measured in absolute terms by disclosing energy consumption. Indicators of intensity include per employee and per unit of revenue or production volume.

Measurement Area	Typical Generic Metrics and Performance Indicators Investors Look For	Related GRI Indicators
Human capital development: training and qualification	• Training and qualification—total or average investment/expenses on training • *Example intensity measure:* Investment or training hours per FTE, or broken down by employee category	LA10
Human capital management: staff turnover, maturity and diversity, absenteeism	• Employee turnover rate • Maturity of workforce—(age structure/distribution); employee average age • Diversity— percent women in workforce, percent minorities • Pay differential between men and women at different levels • Employee satisfaction (as a result of employee engagement) • Percentage of employees covered by collective agreements • Relationship with unions—strikes, days lost	LA1, LA2, LA4, LA13, LA14
Governance		
Board effectiveness	• Board composition—independent directors as a percent of total board membership; separation of CEO and chair role; independent director composition of board committees, such as the audit committee • Board duration—length of individual board member terms (years) • Board remuneration—total amount of bonuses, incentives and stock options, amount of stock based compensation, long-term vs. short-term hurdles (link between remuneration structures and organizational strategy) • Percent women at board level • Indication of risk management policies and implementation	Profile disclosure 1.2, LA13
Stakeholder engagement	• Frequency of key stakeholder engagement • Engagement mechanisms, e.g., meetings, surveys, briefings, use of on-line media • Main issues arising from stakeholder engagement • Steps taken to respond to stakeholder feedback	Profile disclosures 4.14-4.17
Conduct, litigation risks, corruption	• Records of breaches of codes of conduct and the associated costs • Corruption— percent of revenues in regions with transparency rating (such as those developed by Transparency International) and/or number of business units analyzed for corruption risks • Total amount of remediation and fines and, where applicable, expenditure on reclamation and decommissioning • Payments to government(s) and total value of financial and in-kind contributions to political parties, politicians, and related institutions. • Voting right parity	SO2, SO4, SO6

Appendix 2: Additional Resources

REPORTING FRAMEWORKS AND GUIDELINES

Global Reporting Initiative (GRI): GRI produces a comprehensive Sustainability Reporting Framework that is widely used around the world to enable greater organizational transparency. The Sustainability Reporting Guidelines are the cornerstone of this Framework. The G3.1 Guidelines are the latest and most complete version of GRI's Guidelines, offering an update and completion of the third generation of GRI's Sustainability Reporting Guidelines, G3. Launched in 2011, G3.1 includes expanded guidance for reporting on human rights, local community impacts, and gender. While G3-based reports are still valid, GRI recommends that reporters use G3.1, which offers even more comprehensive reporting guidance. The fourth generation of Guidelines, G4, is in development. GRI also offers sector guidance via 15 Sector Supplements.

Climate Disclosure Standards Board: Climate Change Reporting Framework (CCRF) is designed (a) to encourage a harmonized approach to the preparation of climate change-related disclosures that complement financial statements, and (b) to inform investors what management views as the most important climate change-related issues, including those affecting the organization's strategy, economic performance, and prospects.

International Integrated Reporting Council (IIRC): The IIRC, formed in 2010, is developing a globally accepted integrated reporting framework that will allow companies to use a clear, concise, consistent, and comparable integrated reporting format. The IIRC is working to reach a consensus with governments, listing authorities, businesses, investors, accounting bodies, and standard setters on how this should be achieved. The IIRC has held discussions around the world to ensure input from different perspectives, and in 2011 issued its discussion paper on integrated reporting for comment.

World Intellectual Capital Organization: The American Institute of Certified Public Accountants founded the Enhanced Business Reporting Consortium (EBRC), and is actively involved in the World Intellectual Capital Initiative (WICI). The EBR/WICI Framework identifies and defines high level elements and related definitions within five broad categories: a) business landscape, b) strategy, c) resources and process, d) key processes, and e) performance. WICI and its partner organizations have also made significant progress in developing guidelines for measuring and reporting on key performance indicators. The WICI work includes the publication of a comprehensive information framework including industry specific KPIs (see below), and a related XBRL (eXtensible Business Reporting Language) taxonomy.

EABIS Framework for Market Valuation of Financial and Non-Financial Performance: This framework, which ultimately supports company and investor dialogue, was developed to help the valuation and disclosure of non-financial performance. This proposed "laboratory" framework lists key ESG disclosure factors within six key metrics covering (a) employee engagement; (b) customer satisfaction; (c) public perception and supply chain management; (d) carbon emissions, waste management, and lifecycle assessment; (e) product/service development; and (f) ethical integrity and board composition.

Connected Reporting Framework: This framework was developed by The Prince of Wales' Accounting for Sustainability Project to help link a financial report with an ESG report. It can help to make better use of existing financial and non-financial information, particularly by connecting internal management with external reporting. For a how-to guide and examples of its use in practice, refer to the connected reporting section of Accounting for Sustainability's website.

Fédération des Experts Comptables Européens (FEE): *Environmental, Social, and Governance (ESG) Indicators in Annual Reports—An Introduction to Current Frameworks* provides information on documents prepared by various bodies and most commonly referred to when considering the identification and use of ESG indicators.

IFAC PAIB Committee: Forthcoming International Good Practice Guidance on evaluating and improving reporting processes in organizations, to be published in 2012.

KEY PERFORMANCE INDICATORS

WICI Industry KPI Project: Through market collaboration, WICI is developing standardized key performance indicators initially for the high technology, insurance, retail and consumer goods, automotive, pharmaceutical, and telecommunications sectors as extensions to the WICI framework.

The Delphi Project: The project is establishing a set of ESG "super-factors," weightings, and metrics that are validated by a cross-section of Europe's largest institutional investors.

KPIs for ESG: A Guideline for the Integration of ESG into Financial Analysis and Corporate Valuation: This 2010 guideline is for integrating ESG into corporate analysis and valuation, and is a joint project of the European Federation of Financial Analysts Societies and the Society of Investment Professionals in Germany. It lists KPIs for ten major industrial sectors and, within these, offers KPIs for 114 subsectors. Some of the KPIs apply to all industries but many are sector-specific. The guideline also offers basic principles for ESG reporting and recommendations for the presentation of ESG data and, in particular, the use of table formats.

SD-KPI Standard 2010-2014: This 2010 minimum reporting standard for relevant sustainability information in annual report/management commentaries of 68 industries was developed by Dr. Axel Hesse on behalf of the German Federal Environment Ministry and with the participation of leading sustainability investors/analysts. It includes a comprehensive list of sustainable development KPIs by sector.

OTHER GUIDANCE AND RESEARCH

ISO 26000: Guidance from the International Organization for Standardization (ISO) on social responsibility emphasizes the value of public reporting on social responsibility (SR) performance to internal and external stakeholders, such as employees, local communities, investors, and regulators. This emphasis represents an important level of international attention to the issue of reporting, and is aligned with GRI's mission to make sustainability reporting standard practice. Although ISO 26000 does not offer guidance on SR performance reporting, the content does cover a range of topics very similar to that in the GRI Sustainability Reporting Guidelines (also see GRI and ISO 26000, *How to Use the GRI Guidelines in Conjunction with ISO 26000*). The ISO guidance provides a structure for companies to organize their activities, which can influence a company's reporting process.

The Aspen Institute: *Long-Term Value Creation: Guiding Principles for Corporations and Investors* (US, 2010)

The Canadian Institute of Chartered Accountants: *Environmental, Social, and Governance Issues in Institutional Investor Decision Making* (2010) and *Sustainability: Environmental and Social Issues Briefing* (2011)

CFA Institute: *Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors* (2008)

CPA Australia: *Valuing Sustainability Reporting: Perspectives from the International Investment Community* (November 2009)

The Financial Services Institute of Australasia: *Implementing Environmental, Social, and Governance Principles in Investment Decisions* (2012)

The Institute of Chartered Accountants in Australia: Broad Based Business Reporting, The Complete Reporting Tool (2008) and *20 Issues in Building a Sustainable Business* (2011)

Responsible Investment Association Australasia: *The 2001 Benchmark Report*

UN Conference on Trade and Development: *Guidance on Corporate Responsibility Indicators in Annual Reports* (2008)

World Federation of Exchanges: *Exchanges, ESG, and Investment Decisions* (2010)

INVESTOR NETWORKS, COLLABORATIONS, AND RESEARCH

Carbon Disclosure Project (CDP): CDP is an independent not-for-profit organization holding the largest database of primary corporate climate change information in the world. Over 3,000 organizations in 60 countries around the world measure and disclose their greenhouse gas

emissions, water management, and climate change strategies through CDP.

Ceres: A not-for-profit that leads a national coalition of investors, environmental organizations, and other public interest groups working with companies to address sustainability challenges, such as global climate change and water scarcity. Ceres works with investors worldwide to improve corporate strategies and public policies on climate change and other environmental and social challenges across the global economy.

EIRIS: A not-for-profit global provider of research into corporate ESG performance, EIRIS works with clients to develop the market in ways that benefit investors, asset managers and the wider world.

The European Sustainable Investment Forum (Eurosif): The forum is a pan-European network and think-tank whose mission is to develop sustainability through European financial markets. Members include institutional investors, financial service providers, academic institutes, research associations, trade unions, and NGOs. Eurosif's sector reports are aimed at helping the general public as well as policy makers, mainstream asset managers, companies, and pension fund trustees understand risks that lie outside the realms of traditional financial analysis, but may influence investments.

Equator Principles: A credit risk management framework for determining, assessing, and managing environmental and social risk in project finance transactions.

Investor Network on Climate Risk: Partners with investors worldwide to advance the investment opportunities and reduce the material risks posed by sustainability challenges such as global climate change and water scarcity.

The Institutional Investors Group on Climate Change: A forum for collaboration on climate change for European investors, which has also published disclosure frameworks focusing on the business issues and indicators specific to various sectors in the area of climate change.

Principles of Responsible Investment (PRI): This UN-organized network of international investors works together to put six Principles for Responsible Investment into practice, a process that involves more than 800 investment institutions from 45 countries. The UN PRI also recently published *Universal Ownership, Why Environmental Externalities Matter to Institutional Investors*.

UN Environment Programme Finance Initiative (UNEP FI): A global partnership with the financial sector with over 190 institutions, including banks, insurers, and fund managers, working to understand the impacts of environmental and social considerations on financial performance. UNEP FI also supports the National Capital Declaration, which is a statement by the financial sector demonstrating its commitment at the Rio+20 Earth Summit to work toward integrating natural capital criteria into its financial products and services for the 21st century. The Natural Capital Declaration contextualizes natural capital as part of ESG, for the broad financial sector.

International Federation of Accountants
545 Fifth Avenue, FL 14
New York, NY 10017
USA
T +1 212 286 9344
www.ifac.org

IFAC International Federation of Accountants