Finding the Value in Environmental, Social and Governance Performance

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Abstract

To date, managers of approximately $ 30 trillion in financial assets—all signatories to the United Nations Principles for Responsible Investment (UN PRI)—are seeking to identify companies with higher levels of Environmental, Social and Governance (ESG) performance and strong returns. CFOs increasingly find ESG management on their agenda. However, based on insights from Deloitte Sustainability and the CFO study, in 2012, the management of ESG via the financial department varies enormously

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between industries and countries. This chapter aims to provide insights into four key areas which could be considered key links with respect to finding the value in ESG performance. First, the role of the CFOs in managing ESG performance, second, the market value of the respective information, third, the development over time towards a future outlook, and fourth the utility of transparent ESG information (in the form of internal and external reporting) going forward.

14.1 The Value Behind Environmental, Social, and Governance Performance

To date, managers of approximately $ 30 trillion in financial assets—all signatories to the United Nations Principles for Responsible Investment (UN PRI)—seek to identify those companies which achieve higher levels of ESG performance and strong returns.[1] At the same time sustainability management has landed on the agenda of Chief Financial Officers (CFO) (Deloitte 2012). The following chapter aims to provide an insight into the CFOs role in managing ESG performance and the value of the underlying information that is shared with stakeholders both inside and outside the firm. Reporting on ESG performance is presented as a key missing link which can deliver value through facilitating transparency and thereby leveraging the impact of sustainable CSR practices.

14.2 Leveraging Companies' ESG Performance

For nearly all of the world's largest publicly traded companies, reporting on ESG performance is fast becoming the norm. Of the 250 largest companies in the world, 95 % issue separate sustainability reports (KPMG 2011). At the same time the relevance of ESG risks (e.g., consumer boycotts, labour strife, industrial accidents, or extreme weather) to corporate valuations is growing, particularly in today's growth-challenged and volatile environment, where even small shocks from the outside world can determine whether a company sinks or swims. Review of the evidence on investor behaviour confirms that mainstream investors take these types of event risks seriously in their investment decisions—in fact they have been doing so for decades (Koehler and Hespenheide 2013).

Take for example supply chain risks to global companies. In the past decade, we have seen heightened financial risks, regulatory uncertainty, extreme weather, crop failures, commodity price volatility, and social unrest in countries and communities particularly vulnerable to these shocks. Concurrently, most supply chain managers strive to create lean supply chains that are more efficient. However, this only further exposes supply chains to

[1] Introduced in 2006, the UN PRI currently has over 1000 signatories, including asset owners, investment managers, and professional service partners, who seek to integrate ESG factors into investment practice. See www.unpri.org/publications/annual_report2011.pdf.

disruption risks, because, lacking sufficient redundancy (in the form of multiple suppliers of key components), there is no alternative supplier when one fails to deliver. These disruptions can unleash significant ripple-effects across supply chains and have long-term financial consequences (Hendricks and Singhal 2005). For example, companies subject to a supply chain disruption subsequently experienced 33–40 % lower stock returns lasting up to 3 years, a 10 % decline in share price relative to their benchmark portfolios, and a 13 % increase in share price volatility the year after the announcement. Accounting performance also suffered, including a 107 % drop in operating income, a 7 % decrease in growth of sales, and an 11 % growth in cost. Insurers for contingent business interruption also estimate that in 2012 companies were facing 5–12 % higher insurance rates than in 2011 (Lenckus 2012).

The mainstream investor (not only the ESG-focused investor) increasingly pays attention to these types of risks, including ESG issues. There is preliminary evidence that the investor reaction to negative ESG events has increased over time (Flammer 2013). Boycotts and other forms of protest can and do impact stock prices, e.g., news on human rights issues associated with a company have triggered an average $ 892 million drop in market value (Kappel et al. 2009; Davidson et al. 1995; Lenox and Eesley 2009). Public protests on labour and consumer issues, such as product quality, can cause a 1 % drop in stock prices in the days surrounding the event (King and Soule 2007). A general rule of thumb is that one negative story is the equivalent of five positive stories (Baumeister et al. 2001; Rozin and Royzman 2001).

In addition, the rise of social media and private politics—where all types of stakeholders are able to drive an agenda—is beginning to rival the impact of public politics and regulatory processes, including those addressing ESG issues. Social media accelerates and complicates the entire news cycle on a global scale. While traditional high-profile news media are typically still the first to report a new story, it is the dynamic blogosphere that may pick up the story within a few hours and discuss it at length, thus prolonging the focus on a company's short-comings (Leskovec et al. 2009). In this way, ESG issues can gain momentum on social media and continue to erode corporate reputations and investor confidence in corporate management for quite a while.

However, those companies that have signalled to the marketplace that they are prepared for ESG shocks can better mitigate the downside risks, both in the short- and long-term. This makes disclosure on how companies manage their ESG risks all the more critical, because it can help capture investor interest, build trust and goodwill, and demonstrate the long-term value of ESG management. Those that disclose more ESG information are also more likely to enjoy a lower cost of capital according to academic research (Dhaliwal et al. 2011). This focus on finding the value in ESG performance is the missing link which is addressed in this chapter.

Investors focus on management's preparedness for the unknown, for excessive volatility, and managers' ability to execute a business strategy without incurring too much risk. Management competence in these areas requires a better understanding of all aspects of the business. To capture value derived from ESG management, corporate leaders need to

demonstrate to their investors how they are staying or intend to get ahead of ESG risks in their day-to-day management and are building resilience before the next ESG shock. This may require strategic re-thinking of the business, including new product innovation, business model changes, and other steps to increase profitability.

A number of best practices have emerged that show a direct link between ESG initiatives and profitability. *3M* saved up to US $ 1.5 billion since 1975 through their 3P program on the *prevention of pollution that pays* (Miller et al. 2008). The German drugstore chain *dm Drogeriemarkt* achieved growth in sales of 11.3 %[2] in their last business year by focusing on consumer demand for more sustainable products (Meyer and Waßmann 2011). A study conducted by Deloitte (Deloitte Consulting LLP, ASQ 2012) found that companies that are strongly engaged with their suppliers on ESG issues achieve higher earnings in 38 % of cases.

14.3 The CFO's Role in ESG Value Creation Across the Globe—A World of Differences

Organisationally, we see changes in the roles and responsibilities for ESG issues. In recent years, CFOs of international companies have increasingly committed themselves to sustainability and intend to continue doing so. The reason is obvious: Half of the respondents in a 2012 study by Deloitte and Verdantix expect a correlation between sustainable practices and positive financial results. More and more companies sharpen their green profile with investments in the million dollar range (Verdantix 2012). Many companies are issuing a sustainability report, which is used to present their investments and services to investors and other stakeholders.[3] Here, the financial department has to ensure that it is involved in the communication processes in an adequate way, as information is increasingly targeted at investors, who are in fact referring to the information. Finance departments and CFOs also have the appropriate tools to ensure uninterrupted reporting. The Information Technology (IT) infrastructure and the routine of the team members often make it much easier to collect data and check credibility and quality. This is especially important in cases in which the performance in terms of sustainability has an impact on the assurance of corporate data or remuneration.

However, how the CFO agenda has evolved and what connection CFOs see between sustainability and their companies' financial performance differs substantially in different countries and across industries, due in part to differences in regulations between regions and countries.

As the EU is in the process of making disclosure on non-financials mandatory, CFOs from France, Germany and Britain will need to focus more on ESG indicators. For example, about 48 % of CFOs, both in France and Germany, expect that upcoming regulation will strengthen their role in sustainability issues over the next 2 years (Deloitte 2012).

[2] Retrieved from http://www.dm.de/de_homepage/unternehmen/zahlen-fakten/unternehmenszahlen/.

[3] GRI Report Database, Retrieved from http://database.globalreporting.org.

Under Grenelle II companies in France are already required to disclose their sustainability performance in general. In Britain, the disclosure of greenhouse gas emissions for all companies listed on the London Stock Exchange is binding since 2013.

Today German companies already have to include ESG aspects such as environmental or employee matters in their management report, if these issues are seen as relevant for a company. In addition, the management report has to contain statements about future developments, including identified sustainability risks and opportunities. For example, it has to describe how the company intends to minimise risks of production down-times based on scarcity of resources or how legislative changes on product safety affect earnings. Risk management has to be adequately disclosed. For fiscal years starting after 31st December 2012, group management reports (DRS 20) have to present non-financial information in the context of sustainability if they are used for internal management control. This can include customer satisfaction, environmental issues such as emissions or energy consumption, social issues such as employee turnover or training activities, and indicators for research and development or social responsibility in the larger socio-cultural context.

Investors are also invited to demand declarations of companies in which they wish to invest, making the adherence of the German Sustainability Code (DNK)[4] the basis for their assessment. Stakeholders such as investors, employees and insurers are increasingly dependent on reviews by an independent third party to ensure the quality and reliability of sustainability reports to assess the illustrated relationship between ESG performance and business. To increase transparency, the credibility of the declaration should be assured by an independent third party, such as a financial auditor.

Looking beyond Europe, in South Africa for example, non-financial disclosure for companies listed on the Johannesburg Stock Exchange is mandatory since 2002 in association with the King II Report on Corporate Governance. Since the beginning of 2012 around 60 % of South African CFOs have increased their sustainability activities, and 73 % expect to see an even larger increase in the next 2 years (Deloitte 2012).

Australian CFOs are similarly becoming more familiar with sustainability efforts. In the last 2 years, thanks to a growing commitment to the Global Reporting Initiative (GRI), the number of GRI reports in Australia has almost doubled. According to the Deloitte survey (Deloitte 2012), some 40 % of CFOs are accountable to their boards for their company's sustainability strategy; 40 % are always involved in driving the execution of that strategy, while 30 % are frequently involved.

In China it seems that the official Chinese attitudes toward and commitment to sustainability may have already affected local CFOs. The fact that the government's 5-year plan calls for dramatic moves to reduce fossil fuel consumption, promote low-carbon energy sources, and invest in a sustainable future (Voigt 2013), may explain why 54 % of the Chinese respondents in a Deloitte survey say that their involvement in sustainability strategy has increased in the last year at least slightly. Another 54 % expect their role to increase even more in the next 2 years (Deloitte 2012).

[4] See http://www.deutscher-nachhaltigkeitskodex.de.

Despite the fact that the Middle East is one of the most water-constrained regions in the world, sustainability does not seem to be a top CFO priority at some companies. In fact, none of the CFOs interviewed in the 2012 Deloitte study reported that they are accountable to the board for their company's sustainability strategy and only 9 % say that they are always involved in the execution of that strategy. That is likely to change. Some 72 % of CFOs expect sustainability to impact their ability to raise capital at least slightly over the next 2 years, and another 63 % expect it to affect financial reporting.

In light of growing social and environmental challenges, as well as fierce global competition, the pursuit of sustainable corporate development will play a crucial part in whether an organisation will be able to generate a competitive advantage. While the focus has been on publicly-traded companies, today SMEs are also beginning to play a major role in demonstrating their sustainability performance as part of the global supply chains of multi-national organisations. Consequently, in the foreseeable future, investments in sustainability programs will reach a size which CFOs will not be able to ignore. According to Verdantix (2012), the total expenditure in terms of sustainability will reach $ 60 billion (with a turnover of over US $ 1 billion) in Australia, Canada, the UK and the United States. Investments will mainly aim to reduce operational and compliance costs of ESG issues.

14.4 Creating Value Through Transparency in Germany

The most transparent and comprehensive way of disclosing on ESG performance and its relation to the company's value creation today is through the sustainability report. The number of published sustainability reports of major German companies continues to rise and can even be called "state-of-the-art" for all DAX companies. At the same time, stakeholders such as customers, employees, neighbours, NGOs, politics and trade unions come to expect similar transparency on ESG issues from small and medium-sized enterprises (SMEs).

The importance of the German mid-market sector[5] as well as its unique rootedness in local communities and regions can propel sustainable development forward in Germany. External reporting is growing in importance for the mid-market as a means of differentiating from local and global competition. Baked into the DNA of the German mid-market is the principle of the "ehrbarer Kaufmann" (honourable merchant or business person), who as a member of society, ensures a balanced approach to the needs of society, the economy and the natural environment in its operations to preserve the well-being of present and future generations. This characteristic, as well as an the impending turnover on many SME boards—which often results in younger and female leaders—creates a valuable foundation for future sustainable actions and reporting in the influential mid-market sector (Commerzbank Study 2011).

[5] According to its scientific approach and due to the relevance of a practical perspective on mid-market research, the Deloitte midmarket institute has defined companies with revenue of approximately 50 million € and up to 3000 employees as mid-market corporations.

The process of creating a sustainability report in the mid-market follows the same route as that of large multi-national companies. However, small and medium-sized companies often face organisational hurdles to creating a comprehensive, high quality report due to limited personnel and financial resources. This raises the question of how sustainability reporting should be embedded most efficiently and effectively in small and medium-sized companies. Although in many ways a classical communications instrument, the sustainability report requires data on economic, environmental and social issues, which come from a broad range of departments, such as accounting, purchasing, facility management, the HR department or the board itself. Here, an effective support-team for the CFO is crucial, as accurate resource planning is required.

Some of the SMEs have access to information ranging from text material on websites, personnel and social reports, environmental statements and annual reports of their industry peers. Sustainability reports, which have often historically been developed for environmental and social reports, even in large companies, create an opportunity to unite information in one medium. Combining sustainability reporting with existing environmental and safety management systems should be considered when trying to align resources (Steinhardt and Stubenrauch 2012). The result is reduced cost, increased transparency and credibility, as well as potential recognition from stakeholders. Furthermore, investors can gain a holistic view of the business situation, including opportunities and risks, and potential employees can receive insights into the culture and values of the company.

14.5 The Outlook

Recent developments such as the Global Reporting Initiative (GRI) G4, the International Integrated Reporting Council (IIRC) framework and local or regional legislation will set the foundation for a more understandable and transparent linkage between financial and non-financial performance for companies of all types and sizes. Ultimately, this should enable company decision-makers and stakeholders alike to find the value in environmental, social, and governance performance.

Whereas initially, non-financial disclosure has been voluntary in most of the EU, in April 2014, the European Commission finalised their regulation for mandatory reporting of non-financial information in the annual report. The Council and parliament agreed that all large public-interest companies whose average number of employees exceeds 500 need to disclose non-financial information. This accounts for around 6000 companies across Europe. As a result, companies are required to disclose information on policies, risks and results with respect to environmental matters, social and employee-related aspects, respect for human rights, anti-corruption and bribery issues, as well as diversity on boards of directors.[6] Internationally accepted standards, for example the of the GRI[7] framework, the

[6] See http://ec.europa.eu/internal_market/accounting/non-financial_reporting/index_en.htm.

[7] See http://www.globalreporting.org.

ISO 26001 for corporate responsibility[8] or the United Nations Global Compact,[9] will help to standardise and solidify ESG reporting.

14.6 Summary

In conclusion, it can be stated that appreciation of the value inherent in environmental, social and governance management is growing given that:

- Investors are taking a much closer look at ESG risks that might occur or have already occurred. Consequently, negative incidents have a direct impact on company valuations;
- An increased understanding of how ESG issues influence the overall company performance and the potential risks across the company's entire value chain is of relevance to all stakeholders, including investors.

An efficient management of ESG issues and the publication of ESG-relevant information will benefit not only the stakeholders' desire for transparency, but also the corporate reputation and financial valuation in the event of a crisis. Consequently, to address the current missing links identified in this chapter, all market players should follow a holistic approach when implementing decisions with respect to identifying relevant and potentially financially material ESG issues, to ensure better informed and future orientated decisions (Koehler and Hespenheide 2012).

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[8] International Organization for Standardization. See http://www.iso.org/iso/home/standards/iso26000.htm.

[9] See http://www.unglobalcompact.org/.

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