THOUGHT LEADERSHIP 02

Navigating the ESG landscape

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Empowering Business Globally

The world is changing, quickly.

Across the last three years, we have seen profound changes to the way we work. Across corporate spaces, there is a focus on impact and on building a better, fairer and more cohesive world. Businesses have become ever more aware of the challenges that we face today, as well as how they may develop in the future. This is abundantly true of the financial and accountancy industries, who are at the forefront of changes to business practice. Future generations will be left to reckon with the decisions we make today, in ways that can be difficult to foresee.

The rise of Environmental, Social and Governance reporting seeks to address the following areas:

- To integrate wider social issues into the fabric of business strategy.
- To provide a framework to assess how a business interacts with the world.
- To manage how a business appears to investors.
- To inform stakeholders how a business is managing risk.

These areas cut to the heart of how a company is run, demonstrating how well the company is placed to meet the challenges of the future. The quest to reliably measure ESG considers all aspects of operation, making exploration and introspection a powerful method of finding success.

Taking a lead in these non-financial areas can ensure your firm is not only reacting to the world responsibly but is at the forefront of business developments. Praxity Alliance member firms are finding innovative and agile ways around the inherent problems in measuring ESG for their clients and themselves, as well as expanding their understanding of their own purpose as businesses.

> In terms of business priorities, this is at the heart. It doesn't mean that other priorities take a backseat to ESG. Rather, ESG must be integrated into everything that a corporate does.
>
> Just like the evaluation of enterprise risk management, risk was moved from a one-off exercise to be integrated into all decision making within and across a corporation. We need to see ESG in the same light.

Edward Olson,
National Leader,
Environmental, Social & Governance,
MNP LLP, Canada

A Guide to the Three Principles

Environmental
The environmental component looks at how a company is exposed to and manages risks and opportunities, specifically related to themes such as climate, natural resource scarcity, pollution, waste, the company's carbon footprint and other environmental factors. With challenges around meeting governmental targets, assessing the impact on climate change and looking after our world, it's a key area to assess.

Social
The social component concentrates on information about the company's values and business relationships. This can be both inward looking towards company culture, or outward looking to the wider world, including areas such as human rights, community relations, staff pay and benefits, working conditions, safety, inequality and philanthropy.

Governance
The governance component focuses on information about a company's corporate control. Governance can cover issues such as transparency, fairness, accountability, leadership, key strategies, business culture and stakeholder engagement. It could include information on the structure and diversity of the board of directors, executive compensation, critical event responsiveness, corporate resiliency, and policies on bribery and corruption.

Governance is not the area that brings in the biggest headlines outside the business community, but it is perhaps the key element in achieving ESG goals. Without good governance, it is almost impossible to ensure delivery on the environmental and social factors that are such pressing concerns. Good governance can have a positive impact on business, society and planet, while poor governance can lead to strongly negative outcomes; in fact, it is poor governance practices that have stood at the core of some of the biggest corporate scandals in history.

Measuring the value of ESG

With incoming legislation, both in the EU and North America, best practice and guidance are quickly becoming reporting requirements and legal frameworks. Once a specialised area removed from core business strategies, recent efforts have been made to bring ESG data into formal reports that offer a diagnostic of the company as a whole, as well as incorporating these metrics into binding rules and regulations.

Collecting and recording ESG data is particularly challenging. Mostly it is collated and recorded into a spreadsheet for easy reference, though there is a great deal of variation in this. The ESG reporting function is increasingly being moved into the finance team, so that they can apply the rigor of financial reporting processes and controls to non-financial data. Investors are also beginning to ask for independent assurance of the data collected.

Who?
The company's sustainability team, with increasing movement towards the company's finance team. There is a growing trend of employing the services of external assurers to report on a company's behalf.

What?
They report on the most material ESG topics for the business (e.g., commitments, progress, case studies) as well as regulatory requirements.

When?
Externally, reports are usually annual, in line with the financial reporting. Internally, most larger companies now report monthly or quarterly on key ESG measures.

Where?
Some have a standalone sustainability report, some do a report on business operation. Good practice is to have a ESG databook containing all key disclosures, so the data is easily accessible to investors.

There are many variations in how this reporting is performed, what it considers and what standards it conforms to. Reporting can be done internally by the company's relevant teams or outsourced to an external agency.

TBL (Triple Bottom Line) Accounting
The triple bottom line consists of social equity, economic, and environmental factors. This was designed to bring non-financial data into play when reporting on a company's successes and failures. The phrase, "people, planet, and profit" to describe the triple bottom line and the goal of sustainability was coined by John Elkington in 1994 and, with the growing drive for ESG standardisation, has recently been gaining in popularity again.

Integrated Reporting
Integrated Reporting, a further refinement of this idea, aims to bring together different parts of a company's ecosystem. Financial and non-financial information are compiled into one integrated report, which seeks to combine all elements of a firm's running. An integrated report looks at six capitals that need to be assessed, along with their interrelationship:

Financial Capital – funds obtained through operations, investments and financing.
Manufactured Capital – manufactured physical objects, such as buildings, equipment and infrastructure, used in the provision of services.
Intellectual Capital – intangibles such as intellectual property, knowledge, licenses, patents, software and copyrights.
Human Capital – the competencies and capabilities of your people, including their experiences, management skills, motivation and their abilities to innovate and implement strategy.
Social Capital – Institutional and social relationships, including common values and shared behaviours, intangibles associated with brand and professional reputation, along with the social licence to operate.
Natural Capital – all natural resources that support the prosperity of the organisation, such as air, water, minerals, forests, along with natural ecosystems and biodiversity.

Not all capitals are material to every business, although most organisations will need to consider some element of each. These capitals are designed to help firms understand value creation, preservation or erosion - a guideline to ensure organisations consider all forms of capital they use or affect.

Other Frameworks and Guides

ESG relies on several existing global frameworks. Materiality naturally varies by industry, illustrating the difficulties when applying a single framework across all business.

- **The Global Reporting Initiative (GRI) –** focused on the economy, environment and society.
- **The UN's Sustainable Development Goals –** based on global goals and the Nationally Determined Contributions (NDCs).
- **Task Force on Climate Related Financial Disclosures –** to disclose climate-related risks and opportunities.
- **United Nations Global Compact –** non-binding UN pact that encourages businesses to adopt sustainable and socially responsible practices.
- **CDP (formerly the Carbon Disclosure Project) –** not-for-profit charity which collects standardised information from companies on climate change and the use of natural resources such as water and soft commodities.
- **Climate Disclosure Standards Board (CDSB) –** the CDSB Framework helps companies explain how environmental matters affect their performance and show how they are addressing associated risks and opportunities to investors in annual or integrated reports.
- **Sustainability Accounting Standards Board (SASB) –** issues sustainability accounting standards that help public corporations disclose material and decision-useful information to investors in their mandatory filings.

These frameworks are complementary and overlapping and, though legislation is on its way in many markets, do not currently have legal reinforcement in any meaningful way.

In the absence of certainty, several ESG Rating Agencies have arisen. Sustainalytics, MSCI, Moody's and FTSE are all agencies that assess companies globally on their ESG performance, then make the data available publicly.

This is a fast way to gain guidance on ESG, but in truth many Praxity Alliance member firms already report much of this data themselves, with an eye on how quickly formal rules are being introduced, as well as guiding clients toward best practice.

Measuring and reporting on the areas that legislation is likely to cover minimises risk and disruption, rendering the good groundwork firms are doing invaluable.

The Value Reporting Foundation

In November 2020, the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB) announced their intention to merge into a combined organisation, *The Value Reporting Foundation*, which was consummated in June 2021. The VRF has three core resources to consider - the SASB Standards, the International Integrated Reporting Framework of 2013, and a prototype for Integrated Thinking Principles published in December 2021.

The VRF was instrumental in the formation of the International Sustainability Accounting Standards Board (ISSB) which the IFRS Foundation announced, coincident with the COP 26 meeting in November 2021. With the formation of the ISSB, the IFRS Foundation also announced plans to complete the consolidation of the CDSB and the VRF into the new board by June 2022. Establishing connectivity between the different bodies using different methods to explore ESG is an important aim, and the ISSB has set out four key objectives:

1. To develop standards for a global baseline of sustainability disclosures.
2. To meet the information needs of investors.
3. To enable companies to provide comprehensive sustainability information to global capital markets.
4. To facilitate interoperability with disclosures that are jurisdiction-specific and/or aimed at broader stakeholder groups.

This process is currently being finalised and the ISSB aims to issue IFRS Reporting Standards by June 2023, with the fundamental aim of giving ESG reporting a consistent basis and empirical backing, with efficiency and clarity in mind.

The International Accounting Standards Board is currently working with the International Sustainability Standards Board to incorporate the Integrated Reporting framework into reporting standards – the IFRS Integrated Reporting Framework – as the usefulness of this method grows in acceptance.

The EU Corporate Sustainability Reporting Directive

In January 2023, the Corporate Sustainability Reporting Directive (CSRD) came into force in the European Union. This law requires all large companies and SMEs to disclose data on what they see as risks and opportunities arising from social and environmental issues, as well as their impact on people and the environment. This is a strengthening of existing rules around ESG reporting, affecting around 50,000 EU companies in total. The directive also aims to simplify and harmonise such reporting, with mandatory audits and digitisation of the data they report.

The European Financial Reporting Advisory Group (EFRAG) has developed a set of reporting standards that are to be applied territory-wide, according to the principles set out by the EU Taxonomy. It aims to provide clear guidance and reduce associated costs in reporting on ESG metrics, while reinforcing the demand for more robust information from the incoming ISSB standards.

Companies will have to apply the new rules for the first time in the 2024 financial year, for reports published in 2025. This is perhaps the strongest clue to the direction of travel on ESG data.

The EU Taxonomy

The EU Taxonomy sets out a minimum standard of sustainability reporting across the European Union, with the goal of a carbon-neutral continent by 2050. It includes detailed criteria for green certification, as well as emphasising the role of sustainable finance in achieving a successful transition.

Sustainable Development Goals

In 2016, The United Nations ratified the Sustainable Development Goals (SDGs), as part of the Paris Agreement. These SDGs, 17 in total, are:

The 17 goals are broken down further into 169 individual targets, to give action more direction and specificity. While the SDGs are not yet legally binding, governments are expected to take ownership of their responsibilities and establish national frameworks- the Nationally Determined Contributions (NDCs) - to achieve them.

How You **Manage ESG Challenges** Reflects on Your Business

While some social and environmental indices can be demonstrated, some by their very nature are intangible. Having a reliable data set, both internally and externally, can provide a measure of how much progress has been made, how much is left to do, and what the benefits have proved to be. Companies must think of themselves as key players in the society in which they operate.

McKinsey (2022) identifies three levels of ambition in ESG practice -

Minimum Practice – Risk Mitigation – reactive, “do no harm” measures. Limited to hitting the baseline operating standards expected of the company.

Common Practice – Substantive Efforts Outside the Core Business – track trends, implement inclusive HR strategies, run strategic programs, engage with stakeholder groups, use strengths to deliver increased value across ESG metrics.

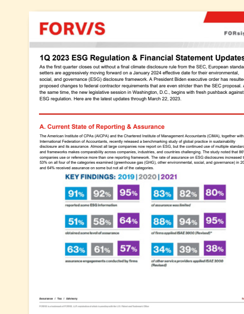
Next Level Practice – Full Integration of ESG into Strategy – embed ESG in capital and resource allocation, improve sustainability internally and externally, take part in full ESG disclosures, increase social impact. Leverage innovation in ESG practice to move the needle on sector standards.

Measurements can be improved over time, with frontrunners demonstrating how important ESG can be to the overall running of a business.

The State of Play in the USA

North America is seeing significant change in laws governing ESG. Forvis report that 64% of their clients obtained some level of assurance in ESG metrics in 2021, which was up from just 51% in 2019. They also report on the ESG climate in each state across the US, with there being radically different views across different jurisdictions.

Common complaints are that ESG reporting penalises industries such as fossil fuels, which several states rely on for a large portion of their GDP. For example, Texas and West Virginia have banned investment by banks and investment funds that they allege have boycotted energy companies critical to each state’s economy. States such as Washington and Wisconsin, by contrast, promote the integration of ESG, while economically powerful coastal states such as California and New York go even further, promoting divestment from certain industries. These issues are part-economic and part-ideological, demonstrating how far ESG’s echoes reach.



Read the FORVIS report

A Critical Lens
There are common and persistent questions about the true value of ESG measurement. These can concern its relevance or centrality, difficulties in measuring and detailing change, or even the suggestion that it has no bearing on financial outcomes. It has also been argued that ESG represents an unstable and contradictory combination of elements, with the suggestion that the acronym will one day be consigned to the past in favour of more precise terms. Admittedly, there are areas in which measurement can be elusive or even impossible, but the long-term benefits of incorporating ESG metrics into broader strategy can be seen across many industries.

ESG rating methodologies are subject to divergence and a subsequent lack of clarity. Despite progress in defining what ESG ratings mean, in the past there has not been a requirement for ESG rating providers to be transparent about the methodologies they use, or for them to apply the methodology consistently. If the market doesn't understand the methodology that the ratings providers are using, then the risk is that the products are not doing what they say they are, and that investors cannot trust the product rating.

Because ESG ratings are a work in progress, bumps in the road are to be expected. No company is perfect, no practice is beyond reproach, errors can be made and actions can have unintended consequences. However, the issues are all in constant movement and it would be a mistake to simply wait and see. Identifying areas that are relevant and that can be referred to consistently is an excellent place to start when assessing ESG concerns.

Addressing a Blind Spot
It should be noted that there are fewer tools to measure social value and a lot more tools to measure the Environmental and Governance areas. This could be considered a "blind spot" by investors and demonstrates the difficulty of applying a standard. However, this is projected to be a growth area in reporting, and one where real and measurable impacts should be expected in future.

Weighing Future Risk

ESG is an extremely powerful tool to assess and measure business risks and to assess whether management is ready for the challenges and unknowns.

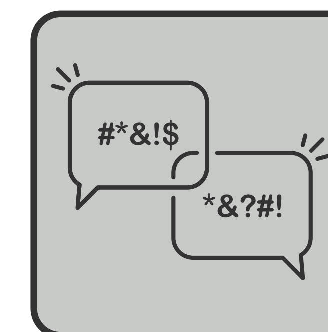
These risks can come in forms that had not been anticipated; for example, in 2008, there was only one societal risk (a pandemic) listed among the top five risks in terms of impact. In 2023, the World Economic Forum (WEF) lists all its top five risks as societal or environmental:

Cost of Living Crisis

Natural Disasters and Extreme Weather

Geoeconomic Confrontation

Failure to Mitigate Climate Change



Erosion of Social Cohesion and Societal Polarisation

This is a profound reordering of priorities, with ESG factors implicit or explicit in every aspect. With ESG and risk increasingly linked, companies have sought to find ways to bring new leaders into the conversation. Finance executives, along with legal executives, can be at the head of enterprise-wide understanding of the environmental, social and governance risks that a company faces. Onwards from this, businesses need to think about how these risks may be monitored, mitigated and proactively addressed.

Alliance Member Firms Are Taking a Lead

Investors want to understand how well organisations are managing the risks associated with ESG issues, seeing this as a key test of management quality. With overlapping and confusing standards becoming binding legislation, there is something of a scramble to report on ESG properly.

Accountancy's traditional position as trusted advisor and authoritative voice is going to be invaluable in the very near future. Praxity Alliance member firms are demonstrating awareness of this, leading from the front in serving their clients and in their own ESG reports.

> Businesses must be willing to assess themselves, be transparent about the findings, and hold themselves accountable. For a short time, they must be willing to temporarily let profits be secondary to doing what's right. No one is asking them not to meet their purpose; but we (society) are asking them to expand their understanding of their purpose.
>
> We must also consider the role of domestic regulation or guidance. Regulation, subsequent socialisation and monitoring is key to ensuring that businesses engage in ESG.

James Kallman,
CEO, Moores Rowland,
Indonesia

Mazar's 2021 Sustainability report uses integrated reporting to assess the firm's health. The company also puts together a risk matrix to assess their value creation chain, taking each risk as material to the running of the company and how the future is approached. Producing case studies for relevant industries and their materialities, the firm demonstrates a great deal of authority ahead of incoming rules, with their online "health check" an easy tool to start businesses on their ESG journey.

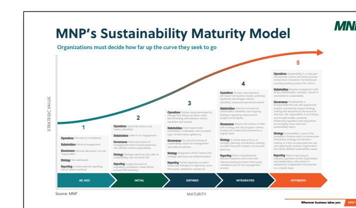
MNP's Sustainability Maturity Model offers a road map for integrating sustainability policies into the fabric of business. The firm also offers an online assessment questionnaire that gives clients an idea as to where they are on their ESG journey. This covers areas such as risk management, strategy, future planning, operations and supply chains, giving their clients a birds-eye-view of their organisation's ability to meet these challenges.

Plante Moran, in their "ESG Reporting: Seven steps to get started" emphasise the target audience for your ESG reporting, considering what you are trying to communicate and to whom. Giving a 7-point plan for what to consider when reporting on ESG, the firm guide their clients through the principles, as well as offering support on relevant metrics to measure. The firm also emphasises taking the opportunity to showcase progress, where ESG reporting evolves and becomes more robust over time.

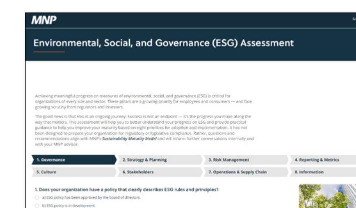
Not only does ESG reporting reassure external stakeholders about company priorities, it also demonstrates a proactive response to contemporary challenges. Being aware of how these different considerations look around the globe is crucial to the continued relevance of the industry, as financial auditors are increasingly in a position of authority. As new regulations and methodologies come into common use in one territory, others will surely follow. Being able to work together across borders means mitigating this element of risk, with firms offering support and expertise when establishing ESG methodology and addressing concerns that weigh on future operation.

Read the Mazars Sustainability report

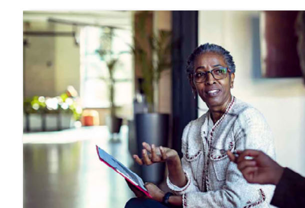
Try the ESG Health check



View the MNP model



Take the MNP assesment



Read the Plante Moran article

Expectation vs Reality

What gets measured gets managed. The adage is certainly true in an ESG context, where there is a persistent danger of doing lip-service or PR in place of real work.

A lack of transparency and real accountability, whether real or perceived, is a clear problem. Doubt can easily turn to cynicism if ESG isn't seen to be taken seriously enough, damaging reputations and outcomes.

It's important to sound a note of reality here; addressing risk properly will not be easy, requiring ambition and creative thinking.

Mazar's 2021 ESG Impact Report uses some figures to illustrate the scale

- The UN estimates that achieving its own SDGs will necessitate investment of around US$5-7 trillion worldwide per year up to 2030.
- To remain below the Paris Climate Agreement target of 2°C global temperature rise, renewable energy use will have to increase six-fold, from 10.5% (2018) to 66% (2050). This would mean an annual investment of $735bn, or £22.5tr in total.
- The UK has set hugely ambitious carbon-reduction goals which are some of the strictest in the world. This amounts to a 68% reduction by 2023, 78% by 2035 and net-zero by 2050.

Read the Mazars ESG Impact report

Making claims about social responsibility or sustainability that cannot be validated is not going to be acceptable to markets.

Clients must find an effective way to quantify their organisation's operations against set ESG criteria, with Praxity Alliance member firms perfectly positioned to benefit from this change of environment.

Effective ESG reporting, as well as being a tool to assess a company from top to bottom, truly matter as part of the aura that any company projects.

Reporting on subjects such as resource use, human rights, corruption and transparency are increasingly used to draw conclusions about the quality of governance, identify exposure to business risks and assess ability to leverage business opportunities. These things can demonstrate a thriving and dynamic company, or conversely, at the worst end of the scale, betray serious problems. It is important that organisations communicate with investors clearly and accurately on these aspects of performance.

The Need for Clarity

Even with ESG standards and ratings gaining a concrete basis, there remain questions which are difficult to answer. Can standards truly be "one size fits all" when the differences in scale and resources between smaller and larger corporations are so vast? How does this trickle down to small and medium-sized enterprises (SMEs) considering that SMEs account for over 90% of global enterprises? Where do we draw the boundaries of ESG factors if they touch so many aspects of operation? How do we assess different industries by a single metric?

Recognised standards will increase the quality of data, for example the Corporate Sustainability Reporting Directive in Europe will mandate independent assurance over all ESG metrics, with reasonable level assurance following by 2028. This means that non-financial data will be subject to the same level of audit as financial data. The Securities and Exchange Commission in the US and the ISSB standards (including in the UK) are likely to follow suit. Core principles must be adhered to for clarity, and tangible and measurable results are important to keep everything on track.

Member firms and their clients will need to do a full gap analysis to assess how the incoming ESG regulations will impact them. They will need to understand what data and disclosures they already have and where the gaps are that they'll need to address. They'll also need to assess the maturity of their ESG reporting processes and quality of their data to ensure they're ready for mandatory assurance. Lighter-touch tools, such as Mazars' aforementioned "Health Check" give businesses a starting point on their ESG journey, ahead of laws and formal ratings giving crucial frameworks for leading more robust inquiries in future. Taking a lead on ESG will be big part of accountancy's trusted role of authority and seniority in coming financial years.

> There is a delicate balance between investing time in what matters now and that which matters for the future. Although those already engaged with ESG feel passionately that the time is now, others see ESG as something which will not be truly important until further down the line.
>
> In order to ensure the entity has the right approach now it would be best to consider the future and current risks to the business. Are there any sustainability or social risks which are material to the business over the next, 1, 2 or 5 years and beyond? If the answer to this is yes, then it would be recommended that the organisation takes action now in order to manage those risks as opposed to wait until a regulation or an approach is mandated and then look to safeguard the business.

Sophie Parkhouse
Partner, Albert Goodman,
England

Looking to the **Future**

Legislation, while long-awaited, is now incoming across the world, with preparation for effective reporting suddenly crucial. While ESG reporting standards are still being defined, the area is under intense focus, with environmental and social factors driving pressure and change.

Member firms are playing an important part in the dramatically changing landscape, planning accordingly for their clients and for their own organisations. Businesses that understand their environmental and social responsibilities and explore ways in which this can be built into strategy will reap the rewards, with financial expertise offering a crucial guide to rules and necessities. Not only does proper ESG assessment reassure external stakeholders about company priorities, but it also demonstrates a proactive response to future challenges. Being aware of how these different considerations look around the globe is crucial to the continued success of the Alliance, as working together leads to a far-reaching view of what is ahead.

Dialogue, collaboration and cross-border thinking are essential to success in these areas of rapid expansion. With well-defined objectives and measurable targets, member firms can build the foundations of a futureproof business for their clients, emphasising the importance of reliable information and clear communication, as well as offering detailed understanding of the relevant legal areas. When aligned with the three ESG components, both business and the wider world can be better prepared for the challenges ahead, with the success of member firms and their clients going hand in hand.

Acronym Glossary

SMEs
Small-to-medium enterprises

VRF
the Value Reporting Foundation

ISSB
International Sustainability Accounting Standards Board

CSRD
the Corporate Sustainability Reporting Directive

SASB
Sustainability Accounting Standards Board

IIRC
International Integrated Reporting Council

CDSB
the Climate Disclosure Standards Board

CDP
the Carbon Disclosure Project

UNSDGs
United Nations' Sustainable Development Goals

NDCs
Nationally Determined Contributions, UN Directive for addressing climate change

GRI
Global Reporting Initiative

EFRAG
European Financial Reporting Advisory Group

UNGC
United Nations Global Compact

What is Praxity?

Praxity is a multi-award-winning alliance, the largest in the world, in 120+ countries with 817 offices in strategic locations and access to over 71,000 business practitioners, accountants and tax experts who really know and understand the traits and risks that lie beyond local borders. Together they share their combined expertise and technical knowledge providing highly customised business solutions and deep regional understanding - driving outstanding results for clients worldwide.

Our member firms amplify competitive advantages, support unique and diverse cultures working to support clients ranging from small ambitious businesses to established global, listed organisations. Business issues don't stop at the border – the solutions shouldn't either.

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