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Integrating ESG Into Your Business Strategy

Why you should integrate environmental, social, and governance (ESG) principles into your business strategy.

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Integrating ESG Into Your Business Strategy

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ESG stands for environmental, social, and governance, and is often used interchangeably with sustainability, corporate responsibility (CR), corporate social responsibility (CSR), and triple bottom line.

Fundamentally, sustainable business practices consider the future effects of business policies and activities. These practices are related to various risks, from climate change to employee health and safety to fraud and corruption. Although ESG concepts have been part of business discussions for many years, the effects of climate change and the COVID pandemic have accelerated the ESG imperative and the need for organizations to adopt an ESG strategy. We will consider in this article some of the reasons to consider integrating ESG into your business strategy as well as briefly cover some of the pitfalls.

Long-Term Value Creation

ESG focuses on developing a long-term strategy that aligns with long-term financial returns. In a recent report entitled “Five Ways That ESG Creates Value,” McKinsey and Company found that “paying attention to environmental, social, and governance (ESG) concerns do not compromise returns – rather, the opposite.” After reviewing more than 2,000 studies on the effect of ESG on equity returns, McKinsey concluded that 63% had positive results and only 8% had negative consequences.

Further, organizations increase long-term value by taking advantage of lower energy consumption and efficient resource use cost reductions. For example, in its 2022 Global Impact Report, 3M announced that its Pollution Prevention Pays program saved more than $2.34 billion since the program’s inception in 1975.

The *Harvard Business Review* (September-October 2020) found that sustainable business practices can help organizations gain better access to resources due to better government and community relations, which could lead to more growth opportunities.

Risk Mitigation, Opportunities for Growth, and Competitive Advantage

ESG factors can have material impacts on companies and have caused significant declines in valuation. Some headline events that have direct relevance to ESG include the Enron accounting scandal (governance), VW’s emission scandal, which was a fraud driven by cultural and ethical lapses (governance), and BP’s Deepwater Horizon rig explosion (environmental), which cost the company more than $65 billion in damages and losses.

The National Council on Occupational Safety and Health placed Amazon on its “Dirty Dozen” list of the most dangerous employers in the country (social). Specifically, Amazon made the list for such workplace issues as employees left without resources or income after on-the-job injuries, workplace fatalities, and suicide attempts. Amazon’s ongoing workplace concerns are a continuing source of bad publicity and reputational damage.

Companies face numerous ESG risks related to climate change; the duty of care; working and safety conditions; respect for human rights; corruption practices; compliance with laws, regulations, and policies; litigation risks; reputational risks; and increased competition among other risks.

In a study by Loyola Marymount University, in all 12 industries examined, the group of ESG-listed companies showed lower stock return volatility than the reference companies – on average, by 28.67%. Understanding your ESG-risk profile and addressing the material issues can help maintain valuations, save your reputation, and decrease market volatility. It is plain that companies that fail to invest in ESG risk significant monetary losses as well as losing customers and talent to competitors who have invested in ESG issues.

Stakeholders Care

PwC’s “2021 Consumer Intelligence Series Survey on ESG” found that 83% of consumers think companies should be actively shaping ESG best practices and that 76% of consumers said they would discontinue relations with com-

panies that treat employees, communities, and the environment poorly.

PwC also found that 57% of consumers say that companies should do more to advance environmental issues. In comparison, 48% want companies to show more progress on social issues, and 54% expect more attention to governance issues. The PwC finding suggests that consumers and employees want to be associated with brands that have a positive impact on the world.

Changes in Demand for Sustainability Information

Stakeholders (those with a direct or indirect interest in an organization) require transparent and accurate sustainability reporting. The needs of these stakeholders can vary. For example, stakeholders may be concerned with reducing pollution and greenhouse gases, fair wages, workplace equality, diversity and inclusion, affordability and access to products, and responsible citizenship.

Investors, in particular, expect an organization to disclose its sustainability performance. In an EY "Climate Change and Sustainability Services (CCaSS) Institutional Investor Survey," 98% of institutional investors use ESG factors when considering investment decisions. The same survey found that from 2018 to 2020, the percentage of investors conducting a structured evaluation of non-financial disclosures rose from 32% to 73%.

Globally, governments are making climate-risk reporting mandatory. As the climate crisis worsens, increased legislation requiring more rigorous non-financial reporting is the response worldwide. For example, Thai law requires information on ESG practices to be included in annual reports, and Hong Kong's climate reporting plan is set to begin in 2025.

The European Council this summer announced that the new corporate sustainability reporting directive amends the 2014 non-financial reporting directive. It introduces more detailed reporting requirements and ensures that large companies are required to report on sustainability issues such as environmental rights, social rights, human rights, and governance factors.

In May, the Securities and Exchange Commission proposed amendments to rules and reporting forms to "include certain climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics."

Take Ownership of Your Organization's ESG Story

With the growth of third-party ESG data aggregators and scorers, your ESG story will be told. Each ESG data provider has developed a methodology to compile scores and aggregate and weigh ESG factors. It is best to get in front of this and tell your own story because the scorers tell it for you.

There are some caveats. For instance, be careful of simply supplying boilerplate information. Boilerplate can be vague and abstract and lead scorers to the wrong conclusions. Depending on the nature of your internal systems, there may be a lack of reliable ESG-related information, but the problem may not be as big as it first appears. Seventy-four percent of Sustainability Accounting Standards Board (SASB) topics are currently addressed in SEC filings.

Greenwashing is also a problem that may leave your ESG efforts for naught. Greenwashing is when an organization spends more resources marketing itself as environmentally friendly than it does to minimize its environmental impact. Greenwashing is a dishonest marketing tactic; too often, stakeholders can see past the hype.

Finally, there is the joint problem of lack of consistency and objectivity. Recently sustainability reporting standards, frameworks, and initiatives have boomed; however, they have done little to promote consistent and comparable decision-useful ESG information. The governance and control over ESG-relevant data are often poor, as is the nature of third-party assurance. This can lead to selective reporting that can easily slip into greenwashing.

Do you work with ESG issues or want to learn more?

Join our ESG Committee!

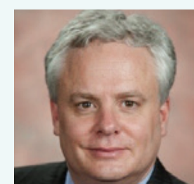
Chaired by this article's author **Tim Hedley**, this new group brings together members in public practice, industry, and academia.

You don't need to be an expert to join! All members are invited to share in the conversation.

Join the group at www.ctcpas.org/Committees or reach out to **Cindy Panioto** at cindyp@ctcpas.org and she'll get you signed up.

The Bottom Line

The ESG train has left the station. Addressing the salient ESG risks your organization faces and reporting on your progress to address those can provide significant opportunities for growth and business resilience. These opportunities may include resource efficiency, cost reduction, innovation, the ability to capitalize on shifting consumer and investor demands, and even reduced government scrutiny.



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