Circling to land

Company's and boards must be prepared to face the messy reality of ESG.

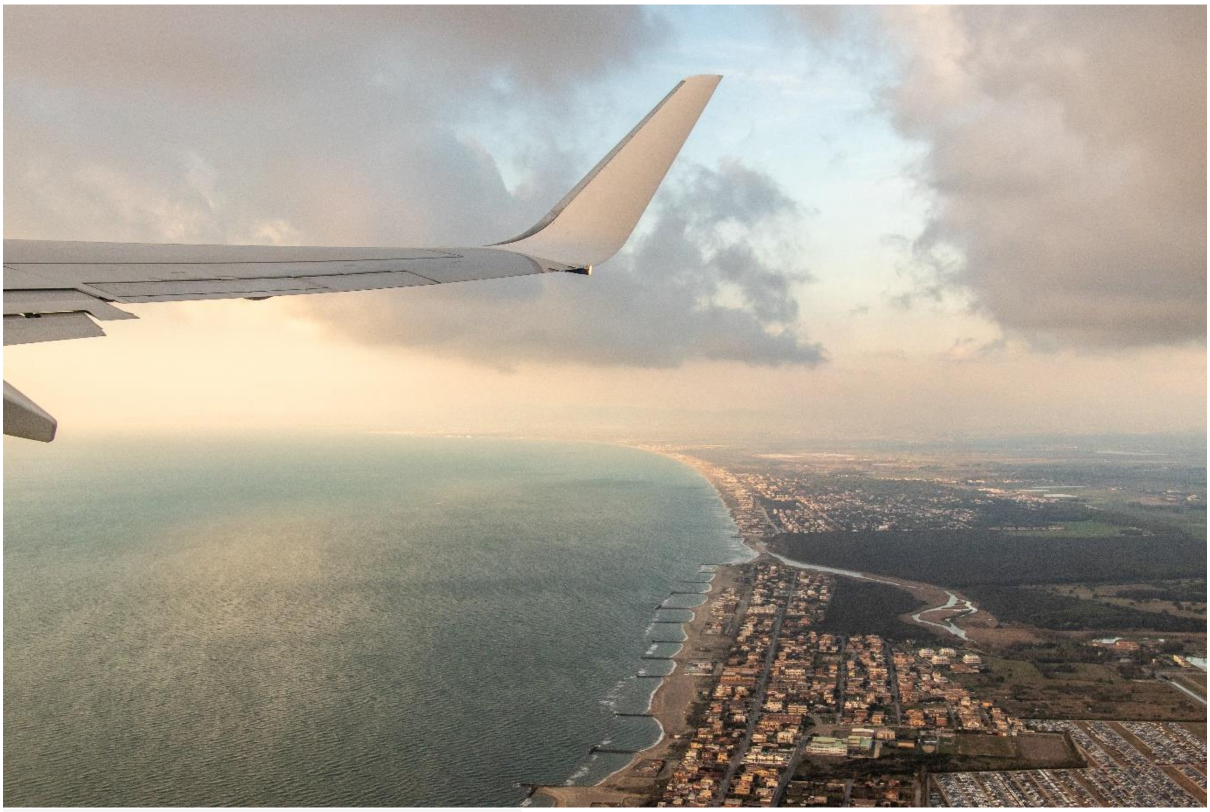

Photo by Angela Compagnone on Unsplash

Environment, Social and Governance (ESG) is all a rage today. Boards and companies are rushing to embrace it, investors are showcasing their green credentials, and what's more, governments are committing to meeting ever stringent targets, with a bit more seriousness, I hope, than their promise to be more fiscally prudent in future. But the ducks don't seem to line up. Companies expect regulators to tell them what to do. Investors hope that they will be given digestible data to integrate with their stock selection. And regulators hope that if they mandate targets in line with global commitments, companies will find the secret sauce.

There are ofcourse those who propose that we will know what to do if only we 'look west,' but fail to acknowledge that while in these markets may have focussed on ESG before we did (- many will debate this), most entities, like their Indian counterparts, continue to approach this tentatively. Surprisingly, even after this head-start they offer no clear road map - infact there is there is even a lack of agreement regarding what constitutes ESG.

Last summer, the U.S. Chamber of Commerce's Centre for Capital Markets Competitiveness (CCMC), together with NASDAQ and a few others, published the findings of their survey regarding practices and the outlook for climate change and ESG reporting from the public company perspective. In sharp contrast most companies appear cautious about the term ESG. Only 8% say ESG encompasses a generally understood set of issues and can be easily defined by regulators. 61% say it is a subjective term that means different things to different companies and is difficult to define. And this is when the survey finds that over the last decade most companies have increased the amount of climate change disclosures that they provide.

Compounding this blurriness is that the conventional cost-benefit analysis will not point the way forward. In the context of climate, it extends well 'beyond the traditional horizons of most actors in imposing a cost on future generations that the current generation has no direct incentive to fix.' Mark Carney, when Governor of the Bank of England, fittingly called this the tragedy of the horizons. Social has its own set of challenges, and companies need to move away from matrices that the west wants companies to report on and target what matters to us as a nation – so expect social to have the steepest climb. For most governance comes first as a company that has strong governance will be managed well in every way. Thankfully it has bright lines drawn out.

This lack of clarity does not mean that boards and companies do nothing till they see the runway. To talk of just two aspects: what is to be done – related to this is who decides and reporting and communication. Unsurprisingly, both point to the need for boards to chart their own path.

Boards need to ensure that the company has rightly identified the ESG risks and the opportunities (- new technologies, product markets etc.). This implies a comprehensive review of financial performance, risk management, supply chains, increased revenue potential and competitive differentiation.

How does the board work on this? Again, there is no one way. A recent BCG study regarding board practices finds that the most common approach (31%) for anchoring ESG into board governance is assigning oversight of these issues to the full board. This is followed by having the issues governed by a dedicated ESG committee of the board (20%) or by having just one member of the board—with no separate committee—lead on ESG issues (15%). The right structure, says report "will depend on factors such as the composition and ESG knowledge base of the board, its existing governance practices, and the maturity of both the company and the board when it comes to addressing ESG topics."

An important part of this exercise is setting both the intermediate goals and final goals; this includes drawing up the transition plans – because having the eventual target stretching out a couple of decades into the future, will mean that these are side stepped. Further, there is the need to tie these in targets to the senior management’s compensation.

Having identified the goals, companies need to report their numbers. The CCM survey cited finds that the basic disclosures are driven by one or more of the standard setting bodies like Sustainability Accounting Standards Board (44%), Global Reporting Initiative (31%), Task Force on Climate-Related Financial Disclosure (29%), CDP (21%). But “46% of the firms surveyed said that almost as much of the additional disclosure are driven by shareholders asking for more information."

So, while I expect the business responsibility and sustainability reporting (BRSR) will provide our boards greater clarity, these will need to be bolstered by additional disclosures to conform to global expectations. And there will be the additional need to communicate on ESG matters with stakeholders, other than investors, and specially employees - who will be driving progress towards these ESG goals. Better still, measuring and reporting the benefits of ESG will make it endure.

Companies and boards must prepare to face the messy reality of ESG. Regulations, no doubt, will standardize ESG disclosures and provide investors and stakeholders with comparable information. But this will not be the end, as multiple requirements and guidance will continue to flow and expectations build up to step beyond the regulatory ambit. Boards, it appears, must prepare to circle, not land.

BS Business Standard

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