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CFO insights: Sustainability: developing key performance indicators

Measuring sustainability is the bottom line

As sustainability, carbon, and climate change initiatives become more widespread, CFOs are likely to be called upon to develop and report sustainability performance indicators, especially those with direct and material financial implications. These indicators are important to meeting evolving disclosure requirements and effectively managing sustainability programs. This paper builds on previous CFO Insights distributions concerning developing a carbon management strategy and tax strategies to support sustainability.

Sustainability KPIs: Why now?

As sustainability grows in importance to corporations, consumers, shareholders, and governments, more companies are producing a public sustainability report. A 2009 Deloitte survey of its largest clients found over 60 percent offered some form of a sustainability report in addition to their regular financial reporting.[1] While these reports are currently voluntary in the U.S., the SEC and other agencies are evaluating mandatory reporting on sustainability performance. Meanwhile, the U.K. and other countries already require reporting of non-financial performance. Today, there are four factors motivating companies to develop and disclose key performance indicators on sustainability. These are:

1. **Stakeholder demands.** Customers and consumers are increasingly interested in how "green" companies are. Wal-Mart has launched the "Sustainability Product Index" which requires suppliers to provide data on their sustainability performance and ensure alignment with Wal-Mart's sustainability goals. This index is a key step toward creating a global set of standards for measuring and communicating the sustainability impact of products and their suppliers, to build a green economy. In a recent survey of businesses, two-thirds of the respondents expected requests to disclose their carbon footprint from the use of their products.[2] Companies like Apple have already taken the lead in disclosing carbon impact. Companies are also experimenting with disclosures such as "carbon labeling," and trying to evaluate if providing this information to consumers influences behavior.

2. **Shareholder expectations.** More than ever, shareholders are taking an active interest in the social and environmental performance of their investments. The Interfaith Center for Corporate Responsibility (ICCR) and Trucost, who track shareholder resolutions, call out sustainability concerns as one of the leading categories of interest for investors. They now jointly publish a page specifically focused on tracking — "Environmental Indicators: New Benchmarks for Evaluating Corporate Performance."[3]

3. **Evolving regulations.** Today, most sustainability disclosure is voluntary, but as trading systems for carbon credits and greenhouse gas emissions regulations mature, we can expect increased requirements for reporting key indicators on carbon. We already see the evolution of more mandatory disclosure in countries like the United Kingdom; and the EPA requirements for reporting from an estimated 10,000 "heavy emitters" of carbon dioxide will go into effect in January 2010. As regulations emerge, mandatory reporting of more social and environmental factors and triple bottom lines will certainly expand.

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[1] *"Lifecycle Assessment: Where is it on your sustainability agenda",* A Deloitte report, 2009, www.deloitte.com/us/lifecycleassessment

[2] *"Lifecycle Assessment: Where is it on your sustainability agenda",* A Deloitte report, 2009, www.deloitte.com/us/lifecycleassessment

[3] *Interfaith Center for Corporate Responsibility,* http://www.iccr.org/shareholder/trucost/index.php

4. **Performance evaluation of sustainability and corporate citizenship efforts.** In the same way that the CFO has traditionally relied on financial indicators to develop an organization's strategy, developing the right sustainability KPIs is essential to create and evaluate sustainability strategy and the organization's performance against objectives. Given the potential impact of investments in sustainability, it is vital to understand and manage performance from the enterprise level down to the business unit and facility, and to thus maximize strategic efficiency.

Sustainability KPIs: What now?

It is almost inevitable that expectations and requirements for disclosure around sustainability will increase. To prepare, the finance organization should work with business units to understand the critical success factors and key indicators that need to be managed, measured, and reported on. In many organizations, sustainability performance management is in its infancy. To understand an organization's key areas of impact and potential opportunity, sustainability performance indicators should be measured at the most granular level that's practical to implement.

KPI development begins with an assessment of an organization's key areas of impact, and identifying where those intersect with areas of CFO responsibility. For example, how would the internal audit process work differently — should it incorporate more review around carbon, water, and energy related activities? What indicators would be vital to this change? All major finance processes can be examined to identify what new indicators become salient when sustainability issues are included in processes such as the financial close or treasury processes. For example, are carbon emissions tracked and hedged by treasury, and does the financial close process give a timely and clear picture of assets and liabilities related to carbon offsets?

Assessing how core finance processes can incorporate sustainability issues and new assets and liabilities and a consideration of evolving regulatory requirements can help frame key KPIs for sustainability. These KPIs are likely to evolve over time. Basic indicators are likely to be absolute measures of critical resource uses and costs. Energy, greenhouse gas (GHG) emissions, raw materials use, solid waste and water use, and effluent are all possible considerations. At the next level, organizations are evaluating each indicator on a relative basis, like assessing the GHG emissions per unit of product, or water used in a specific process. This level of granularity is critical to understand where areas of opportunity may be and measuring the performance of specific initiatives. More mature indicators measure performance in context. These include measures like carbon emissions relative to climate change mitigation goals, water use relative to available local supplies, solid waste emissions relative to landfill capacities, social impacts relative to social needs, etc. Best-in-class organizations are using this type of thinking to understand where the greatest opportunities and potential risks exist in their operations.

Another emerging factor that is influencing the development of KPIs is the concept of lifecycle assessment (LCA). This assessment identifies all the processes in a product system by which inputs are converted to outputs, and their resulting environment impacts. It starts by framing a "product system" and establishing the boundaries of the system. A comprehensive LCA details every material input and conversion process to quantify and track all inputs such as electricity, fuel, water, and other raw and intermediate materials consumed, and their impacts and outputs like carbon dioxide emissions and solid waste. LCA efforts can vary in data intensity and depth — but even low data intensity assessments can at least begin to isolate key performance indicators.

Sustainability Performance Data: How will it be managed?

With the introduction of these new indicators and sources of data, CFOs will need to be able to efficiently gather, store and use this information to make informed investment decisions. Although there is still considerable uncertainty on effective sustainability performance management indicators, new software is becoming available to track indicators and estimate impacts from an enterprise level down to a single facility, processes or product. In addition, until regulation and guidelines are established, CFOs will need to guide their companies' policies for public disclosure of sustainability KPIs in an uncertain environment. For example, few people understand what carbon labels really convey when they are included on products. It will take some time before customers and investors develop the context and the understanding of what is a good measure indicative of a low-impact product and what's lagging behind.

Sustainability KPIs: What are the payoffs?

So why should finance organizations invest now in understanding and measuring sustainability KPIs? Because many of these indicators are not just a measure of sustainability performance; they're actually indicators of inputs and outputs that can identify significant savings or in some cases revenues, and can contribute to enterprise cost reduction. For example, knowing a company's energy footprint can be vital to unlocking government sponsored tax credits and incentives for improvements that reduce the company's energy costs. Investing in KPIs now also positions an organization to be more competitive in the future. It seems inevitable that legislation will require a level of mandatory disclosure for large companies, and building an inventory and mitigation plan now creates options for carbon trading and compliance with emerging and changing government regulations and disclosure requirements later. If an organization wants to look even further ahead, water scarcity and cost will almost certainly become an increasingly pertinent issue in developing countries, and even our own Southwest. Understanding and optimizing a product line's water use could be the main driver in deciding where it's manufactured, or if it's profitable at all. In an environment where resources and energy are becoming increasingly important, KPIs will become vital to tracking financial success as well as to understanding environmental and social risks as they become more salient to organizations.

Building sustainability KPIs can also help the CFO be a better partner to business units by examining their operations with a new lens, and investing to take advantage of these new found opportunities. The CFO can provide innovative financing structures which leverage tax incentives for capital improvements that reduce energy and GHG emissions or conserve other resources. The measures could also help leading companies to go beyond performance and risk evaluation, to identify ways of transforming and improving business performance efficiency over time. As the drivers of sustainability continue to become more relevant to all facets of an organization, from the facility level to the C-suite, the organizations that measure and manage sustainability most effectively will see benefits to their brand, stakeholder engagement, retention and to the CFOs most important indicator — the bottom line.

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