Managing ESG performance

Compliant, insightful integrated reporting
Businesses affect economic and social prosperity—and reap its benefits—in many different ways. But it’s widely recognised that previous success in optimising financial aspects of a business incurred environmental and societal costs. According to the Intergovernmental Panel on Climate Change, businesses should now be striving to cut global carbon emissions to ‘net-zero’ by 2050, to keep climate warming to 1.5°C. Opting out of this reality is no longer tenable. Sustainability reporting standards and frameworks will help companies enhance transparency and communication of their climate-change data and efforts. In this time of transition, a company’s finance function can be a natural leader in organisational transformation: identifying value drivers, gauging the resilience of business models and supply chains, and determining what broader risks the company faces.
Managing ESG performance

Introduction

The voices of financiers, investors and society at large are growing louder. They're demanding transparency of environmental, social and governance (ESG) performance, as well as comparability and reliability. These demands are—or should be—leading all organisations to tell the whole story of their value and true impact on society. This is reflected by a drastic change to our society’s view of desirable and viable economic models; we’ve taken a sharp turn toward the purpose-driven and broader performance of organisations, and all roads lead to a net-zero strategy.

The net-zero signposts are your management team’s definition and valuation of purpose, vision, culture and ways of working. If one of those signposts points in the wrong direction, you may need to amend the purpose, for example, to address relevant principles of governance, planet, people and prosperity—what the World Economic Forum (WEF) calls the four pillars (4 P’s). Above all, you should be acknowledging public commitments made, and practising authenticity in reflecting how the business is run.

Deloitte’s ESG Strategy Wheel (Figure 1) can be used as a framework to measure and optimise your organisation’s true value. Its four interconnected quadrants examine long-term financial and non-financial value drivers, specifically focused on carbon emission targets. The wheel aligns with leading global standards of sustainability reporting, such as WEF guidance, EU Directives and the Task Force on Climate-related Financial Disclosures (TCFD) framework.

Financial controllers and CFOs are perfectly placed to enhance their organisations’ financial reporting frameworks, incorporating ESG elements that will meet internal and external reporting requirements. In the following sections we’ll examine each of the Strategy Wheel’s four quadrants and their building blocks, to help you and your company manage performance toward a net-zero strategy.

Figure 1: ESG strategy wheel

The 4 quadrants of the Deloitte ESG strategy wheel are connected and naturally hang together as if it were an ecosystem in itself. The way management defines its purpose, its vision, its culture and the ways of working is what makes it a ‘ESG’ strategy. The 4 quadrants each break down into three building blocks. The 4 quadrants of the ESG strategy wheel and the building blocks will be further discussed in the next chapters.
Purpose, leadership and culture

The journey of any undertaking starts with a vision and embedding its purpose into leadership and the culture. Our collective view on desirable and viable economic models has changed drastically and focuses on the purpose-driven and broader performance of organisations. Increasing pressure from funders, investors and society at large for transparency on ESG performance and a growing demand for comparability and reliability will lead to organisations telling the whole story of their value-add and their true impact on society. Integrated thinking helps companies to understand their enterprise value creation process in the short, medium and long term.

Consider and if needed amend the purpose of the company to address relevant matters on governance, planet, people and prosperity. This should take account of public commitments made and needs to be authentic to reflect how the business is run.
Managing ESG performance

Setting up for success

**Strategy and risk appetite**
Defining a sustainable strategy requires objectives that extend beyond shareholder value to integrated stakeholder value, and from short-term to long-term timeframes. Envision how the economy will likely transform as it moves toward a low-carbon footprint. Set aside existing perspectives about what your industry looks like and who your competitors are, and adopt a ‘systems’ view to understand where value is likely to be created—and destroyed.

Champion any competitive advantages in your strategy. Maybe that’s access to resources (e.g., natural resources, data). Or it could be knowledge—of technology (e.g., big data analytics, advanced AI, IoT, edge computing, blockchain, cloud) or process. And let’s not forget human capital and culture, as well as access to networks of key stakeholders (e.g., customers, suppliers, governments, partners).

**Operating model**
Sustainability performance and ways of working are inextricably linked. On the functional process level, value in a low-carbon economy might be found in avoiding, reducing or mitigating emissions. But unearthing material sustainability value in your operational model, and addressing risks, requires new ways of working and integrated thinking among finance, sustainability, operations, HR/talent and supply chain stakeholders. Don’t focus the lens exclusively inward. The transition to low-carbon operations demands that new partnerships be formed and agreements with suppliers and customers be revised.

**Accountability and responsibility**
When organisations hold employees accountable, there tends to be a boost in commitment, morale and motivation, leading to higher performance in meeting sustainability targets. Foster ownership of sustainability by:

- Demonstrating responsibility and accountability through visible actions and tone at the top
- Providing opportunities to learn from and/or contribute to sustainable practices
- Teaching staff about their responsibility and the organisation’s perspective on sustainability
- Rewarding employees who take responsibility
- Integrate ESG information in the operating model and ensure the same robustness when holding employees accountable

Consider general implications for strategies, competitive advantages, capital allocation, costs and revenues and organisational insights—enterprise wide and in regions/markets where specific implications of climate change are likely to arise.

Aligning and optimising internal processes, but extend your climate-change approach to the ‘holistic system of systems’.
Establishing boundaries

Policy framework
Because a policy framework typically steers development—by presenting the organisation’s philosophy and establishing a management mandate for implementing it—sustainability should represent key supporting beams of that framework. Incorporate the organisation’s views and goals throughout, clarifying what sustainability achievements are desired.

Such a framework will help your organisation (and employees) conduct business responsibly. It also promotes long-term value creation via sound ESG practices, encouraging transparency, accountability and positive development impacts (e.g., the UN’s Sustainable Development Goals, or SDGs). In addition, a clear policy framework will guide your organisation’s materiality setting as well as ensure an appropriate context-based focus to take legitimate stakeholder and broader ecosystem dimensions into account.

Business requirements
To commit to the SDGs with actionable and manageable efforts, business requirements must be operationalised and clarified based on specific targets. Derive business requirements from:

- A circular economy (e.g., maximise the use of products/materials that incorporate recycled content)
- Mobility (e.g., reduce CO2 emissions via public transportation and/or an electric fleet)
- Community (e.g., minimise impact on local residents and businesses)
- Diversity (e.g., of race, nationality, gender)
- Future proofing (e.g., designing buildings and properties resist climate change impacts)
- Supply chains (e.g., locally sourced or fabricated materials to support the local economy, minimising transportation).

To determine appropriate business requirements, try mapping out how value will be created in the future environment. See Figure 2 for an enterprise value map that links strategy, capability and operational execution, current/future performance and financial/non-financial indicators.

Stakeholder: Value

Integrating sustainability in your policy framework to promote appropriate behavior, manage organisational activities, ensure consistent and efficient operations and reduce the risk of non-compliance.

To ensure that key sustainability risks and opportunities are addressed, clearly define the desired sustainability outcomes in business requirements.

Figure 2: Enterprise value map

Example: KPIs to measure the success of performance on value drivers (operational and financial performance).
Risk management

If your company meets the criteria under the Corporate Sustainability Reporting Directive (CSRD), you’ll be required to certify the establishment of a risk and control framework safeguarding and governing reported ESG information. This means integrating specific sustainability risks into the same control environment and Enterprise Risk Management (ERM) processes as are used for financial information.

As a foundation for this endeavour, the Task Force on Climate-related Financial Disclosures uses the Committee of Sponsoring Organizations of the Treadway Commission’s ERM framework. Think of climate-related risks as falling into two major categories:

Risks related to the transition to a lower-carbon economy
A. Policy and legal risks—policies constraining actions that contribute to climate change or that promote adaptation to climate change
B. Technology risks—the development and use of emerging technologies (eg, renewable energy, carbon capture and storage), among other factors that will affect the competitiveness of certain companies
C. Market risks—shifts in supply and demand for certain commodities, products and services as climate-related risks and opportunities are increasingly considered
D. Reputation risks—tied to changing customer/community perceptions of a company’s effect on the transition to a lower-carbon economy

Risks related to the physical impacts of climate change
E. Acute risks—event driven, including increased severity of extreme weather events
F. Chronic risks—long-term climate shifts that may cause higher sea levels or chronic heat waves

Now combine those with the common risk categories of strategic, financial, operational and compliance; this exercise will enable you to assess, prioritise and integrate specific climate-related risks into an existing ERM framework. For example, strategic risks would cover competition and changing customer preferences, such as opting for products with a smaller carbon footprint. Financial risks could include credit risk, liquidity risk and tax exposure, such as the interest rates rising as lenders consider climate change.

Just a warning: Your assessment will be complicated, because climate-related risks will likely have:
- Different implications on local, regional and global scales
- Longer time horizons and long-lived effects
- Changing magnitude and nonlinear dynamics
- Complex relationships with systemic effects.

Here’s where scenario modelling techniques are useful (see Figure 3 for an example), provided that sufficiently lengthy time horizons are considered. In scenario analysis, mechanisms for internalising externalities are important to assess transition risks, and opportunities. These might relate to government (taxation, regulation), civil society (public voice in the media), technology (transition to and availability of), investors (in investment and lending strategy), corporates (incorporating the cost of externalities into business practices) or consumers (buying behaviour, increased concerns or even stigmatisation of a sector). Try prioritising risky by their severity (livelihood, impact), then evaluate the severity relative to risk appetite. Also, set appropriate timeframes, considering that climate-related risks may have implications beyond 5–10 years.
Budgets and operating targets
Climate-related targets should be quantified, whenever possible — these targets are based on a set of recognised metrics, so the quantification should reflect the level of historical, current and forward-looking climate-related risks and opportunities.

It may not be best practice, but it’s certainly common practice to initially report on what is available rather than on what is needed. Why? Because a sizeable investment is often necessary to identify the data needed and to implement and integrate new systems, data structures, processes, and controls that will let you present reliable, timely information.

It’s crucial to press onward from current metrics to future targets. The table below offers some useful metrics for measuring physical risk and transition risk that are derived from the TCFD framework and core metrics, and disclosures from the WEF 4 P’s model.

### Table 1: Climate-Related Metrics E.g., 4

<table>
<thead>
<tr>
<th>Metrics</th>
<th>Metric detail</th>
<th>Unit of Measure</th>
<th>Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>GHG emissions</td>
<td>Absolute scope 1, scope 2, and relevant, material categories of scope 3 emissions, as well as carbon intensity</td>
<td>MT of CO2 equivalent</td>
<td>Reduce net Scope 1, 2, 3 emissions to zero by 2050, with an interim target to cut emissions by 70% relative to a 2016 baseline by 2035</td>
</tr>
<tr>
<td>Carbon price(s)</td>
<td>External and shadow/internal carbon price</td>
<td>Price in local currency, per MT of CO2e</td>
<td>Increase shadow carbon price to $150 by 2030 to reflect potential changes in policy</td>
</tr>
<tr>
<td>Proportion of assets exposed to physical risks</td>
<td>Assets and/or operating, investing, or financing activities materially exposed to physical risks, based on key categories of commonly accepted risks</td>
<td>Percentage</td>
<td>Reduce percentage of asset value exposed to acute and chronic physical climate-related risks to 20% by 2050</td>
</tr>
<tr>
<td>Amount of senior management remuneration</td>
<td>Remuneration impacted by climate considerations</td>
<td>Percentage/amount in local currency or weighting</td>
<td>Increase senior management variable remuneration related to meeting climate targets to 20%</td>
</tr>
<tr>
<td>Amount of expenditure or capital investment</td>
<td>CAPEX deployed toward climate risks and opportunities</td>
<td>Local currency</td>
<td>Increase climate-related capital budget to $100 million/20% of total CAPEX</td>
</tr>
<tr>
<td>Economics on Climate-related technologies</td>
<td>Return on investment, and payback periods for different technologies</td>
<td>Local currency</td>
<td>ROI of new CCUS technology &gt;10% and payback period of &lt;10 years</td>
</tr>
<tr>
<td>Climate insurance costs</td>
<td>For impacts of extreme weather events e.g., cyclones, hurricanes, floods, drought</td>
<td>Local currency</td>
<td>Reduce insurance costs 30% while maintaining same risk profile</td>
</tr>
<tr>
<td>Reputation: Customer loyalty and retention level</td>
<td>Customer feedback, and market research to track customer sentiment and changing preferences</td>
<td>Net promoter score</td>
<td>Net promoter score to be above 8.5</td>
</tr>
</tbody>
</table>
In formulating forward-looking targets, make them:

- Relevant (addressing material climate-related risks)
- Understandable (especially when reported externally)
- Verifiable and objective (with documentation of audit trail)
- Integrated (in key business processes)
- Aligned (with strategic goals).

Let these targets inform your budget, and incorporate internal carbon pricing: an internally developed estimate of carbon-emission costs. The latter can be an incentive to drive energy efficiencies that will reduce costs, and to guide capital investment decisions.

Incentives and remuneration

‘What gets measured, gets managed’ is a famous quote from Peter Drucker. Investors and other stakeholders will increasingly monitor sustainability performance and hold executives accountable. If you struggle to convert targets into outcomes, consider how you can reflect those targets (and metrics) in incentives for directors and managers. But keep in mind that striking the right balance between joint targets and individual targets is critical, especially given the interconnected nature of sustainability metrics.

You can validate the effectiveness of an incentive scheme by adopting an outside-in view: Is the company truly making an impact on environmental and social matters, in the eyes of the public? Before rewarding executives, take advantage of the many useful tools that can give good insights into the perception of company performance, by analysing news feeds and social media.

Performance management

Externalities in national economic policymaking and individual corporate decision-making now need to be internalized in the operations of every government, company and individual community. It’s time to embed the WEF’s 4 Ps in your targets, and connect them to financial returns.

Implementing a framework of performance management is a top-down exercise that includes:

- Setting targets that incorporate the 4 Ps and reflect the purpose of the company and commitment to actions
- Establishing metrics/key performance indicators (KPIs) that help track performance against targets
- Implementing systems, processes and controls to collect information and enhance managerial accounting and reporting

An efficient approach is to start with any existing reporting and risk-management framework, then integrate the climate-related reporting aspects. Be sure to report on the context of the true impact of a business: Are polluting assets located in a densely populated area? What’s the interaction with the local communities? And what has the company done to reduce carbon emissions?

Try basing the design of the ESG reporting framework on agile design principles. This will enable it to absorb regulatory and other changes over the years while yielding reliable and timely performance insights by combining financial, environmental and social reporting.
Managing ESG performance

Management information
Each internal stakeholder in your organisation has unique information (reporting) needs; these vary according to role, responsibility and accountability. So it’s vital that you clearly dictate the roles and responsibilities of businesses and functions to minimise report duplication and time spent creating, maintaining and reconciling multiple reports. Figure 4 depicts a common information and data model with a clear reporting structure.

Control frameworks
When business processes and the reporting environment are automated, we see an immediate effect on the control and assurance model of an organisation. The controls related to automated processes are often automated as well, and embedded in the business processes, often leading to immediate efficiencies.

Assurance
In the current regulatory environment, non-compliance with existing, mainly voluntary standards and lack of assurance brings no—or limited—consequences. Regulatory bodies advocate a progressive approach for strengthening the assurance of governance.

Figure 4: Management information model

Rationalize the number of reports and automate via standardised reporting. Invest in common data structures, (semi-)automated workflows and analytical capabilities often yield great return as they add to resilience in a dynamic, complex and uncertain environment.

A company that uses process automation and technology-enabled solutions for (near-)real time reporting will need assurance on a nearly real-time basis. As a result, controls become more preventive than detective, so that value does not instantly leave the company when an anomaly arises. A disadvantage that’s often pointed out is the lesser adaptiveness of automated controls to new circumstances (but the same can be argued about manual detective controls).

Favour preventive controls for automated business processes, and understand that the responsibility for maintaining effectiveness may move from business assurance owners to process owners.
Managing ESG performance

sustainability information. Initially you’d start with appointing an auditor to express a ‘limited assurance’ opinion about compliance of the sustainability reporting with EU requirements. But preparing for complying with the CSRD won’t be easy, as the standards are still evolving.


You’ll be required to certify that an adequate risk and control framework has been established, safeguarding and governing reported ESG information. When that time comes, ensure the scope covers information that is qualitative and quantitative, is forward looking and retrospective, and spans various time horizons of the sustainability reporting with EU requirements. But preparing for complying with the CSRD won’t be easy, as the standards are still evolving.

Furthermore, the European Commission announced a focus on “double materiality” which requires an inside-out and outside-in perspective on performance and public reporting. The Directive prescribes disclosure of (the materiality) of:

01. Environmental and social impacts on companies’ finances;
02. Companies’ impacts on people and planet.

Don’t wait for regulation—focus on future material topics and real impact, including ESG issues that are truly material to the organisation. Build internal controls for this information, as well as data access and management, to ensure long term quality and credibility of the non-financial information.

Leading global reporting initiatives

Successfully creating enterprise value and business resilience depends on embedding ESG value drivers into strategy, business model, risk management, policies, KPIs, targets and governance. The following global initiatives provide guidance and proposed legislation for non-financial reporting:

- The voluntary WEF International Business Council defines a core set of Stakeholder Capitalism Metrics (SCM) and disclosures to align performance reporting against ESG indicators, and uses the 4 P’s.
- The EU’s Sustainable Finance regulation is a set of measures to help direct capital toward sustainable activities across the EU. The EU Taxonomy is effective for all EU listed and large companies, as of reporting year 2022. The CSRD is expected to be effective as of reporting year 2023. The CSRD specifies that companies shall report qualitative and quantitative sustainability information on strategy, business models, risk management, policies, KPIs and targets, and governance.
- The G20 Financial Stability Board’s Task Force on Climate-related Financial Disclosure offers recommendations for governance, strategy, metrics and targets for companies to disclose details of their climate-related risks and related opportunities.

Many other initiatives focus on transparency in integrated reporting, such as the Carbon Disclosure Project, International Integrated Reporting Council, Climate Disclosure Standards Board, Sustainability Accounting Standards Board, and Global Reporting Initiative. In November 2021 the IFRS announced the formation of the International Sustainability Standards Board.
Companies that perform well on material sustainability issues enjoy the strongest financial returns. Success aside, your stakeholders and society want to see all the hard work and results behind your returns—and not just in monetary terms. Financial reporting, supported by its systems, data structures, processes and controls, has matured over decades, and now ESG reporting must follow suit.¹

Deloitte works with companies to transform them into purpose-driven, responsible businesses that measure more than financial value. We focus particularly on the design and implementation of:

• Climate-related strategies
• New integrated operating models
• Effective processes for risk identification and scenario analysis
• A performance management system based on financial and non-financial targets
• A foundation that ensures timely and reliable data capture, management and governance
• Compliant and insightful integrated reporting
• Management control and assurance over effectiveness of controls.

If you’re dealing with any of these issues, let’s discuss how we can help you manage ESG performance and accelerate your responsible business objectives. Please find our contact details on the next page.

Conclusion: Firming up your ESG framework
Endnotes


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