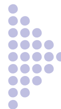
DT Director Today® A Monthly Journal of the INSTITUTE OF DIRECTORS, India

ESG Disclosures are Necessary but Not Sufficient

Businesses must continually integrate Sustainability into Core Operations



*Dr. Harry G. Broadman

Rarely a day goes by without the financial news reporting on adverse reactions by businesses, trade associations, lobbyists, think tanks, and politicians around the world about the requirements for commercial entities to file reports disclosing the extent to which their activities had an impact on Environmental, Social and Governance (ESG) matters in the local, national, or global economic landscape.

This is hardly unexpected. After all, such government requirements are anathema to these parties because they believe reporting on these actions or inactions according to their alignment with ESG objectives and principles could affect the returns on their engagements with investors.

Of course, such returns can be positive or negative, depending on the substance, magnitude, and credibility of the firms' reports. Among most business executives and boards, there is a presumption they will be negative. Indeed, from the scale, scope, and frequency of public outcries from those parties about such ESG reporting and disclosure requirements, it is fair to say they assume such adverse outcomes will be predominant.

But the converse can also be true: firms that engage, or publicly commit to engage, in business activities that are aligned with ESG objectives and principles—and willingly, if not proactively, disclose reports on them in line with otherwise mandated standards—presume they stand to benefit in the marketplace from investors, customers, suppliers, and the like.

> Mandated ESG disclosures cannot be asymmetric, with firms shining the light only on positive outcomes they have achieved.

It is hard to overstate the importance of this point: the emerging global regulatory regime for companies undertaking ESG disclosures drives firms to engage in an ex post exercise, akin to requirements for financial audits. In traditional accounting, such a rear-view mirror or static approach makes sense. However, assessing the progress businesses are making in achieving sustainability—an inherently dynamic process—requires a prospective paradigm.

Although the prevailing bet on the probability of such conduct being displayed is deemed to be much lower than the obverse, an assessment of business commitments made at COP26 in

November 2021 suggests otherwise. Indeed, these data show that the concreteness and specificity of these commitments—especially with respect to integrating advances in technology into business operations to enhance sustainability—are far more advanced than those made by governments. Of course, the proof is in the pudding.

Rationales for ESG Reporting Disclosure

This raises two fundamental principles about the modus operandi underlying the rationale for the pursuit of government-mandated ESG reporting and disclosure requirements.

First, there is a belief that reporting and disclosure per se will create the necessary incentives for the sought-after operational changes in the ESG conduct of firms and that such incentives will be realised, thus inducing changes in the way firms function.

Of course, such changes will rarely, if ever, manifest themselves in the short run within a modern business; indeed, they are usually complex, multifaceted undertakings, often involving innovation. The process tends to be an evolutionary rather than a revolutionary one, particularly in large multinational enterprises, especially those that provide multiple products or services and operate in disparate geographies.

The central point is this: whatever reporting obligations are taken onboard, there is a strong belief—almost zealousness—that the mandated disclosures and the reports generated therefrom are, in and of themselves, agents directly propagating fundamental business transformation leading to enhanced corporate sustainability. After all, this would seem to be the raison d'être for requiring such disclosures.

Yet even if that train of reasoning becomes a reality, the simple fact is that mandatory ESG disclosure simply is not a substitute for both embracing and actualizing sustainability within businesses' operations.

The same should be said with respect to the expected impacts of “ESG investing" a topic that receives undue attention by ESG activists, governmental agencies, and the business press around the world.

ESG investing generally refers to the practice of external institutions engaging in “portfolio investment” in companies. The rationale for such activity is that it will induce durable changes in corporations' operations. But let's be clear: portfolio investments are essentially passive actions taken by third parties. As a result, they rarely, if ever, are substitutes for “direct investment” by firms that make concrete, structural changes—often centred on embracing new technology—that incorporate sustainability in their business operations.

In short, integrating sustainability operationally into an enterprise's fundamental functions that engender changes in production processes, hiring practices, and disposal of waste, among other dimensions is a market action. Disclosure by firms about the degree to which they have complied with regulations according to prescribed reporting standards is, of course, important. More likely than not, regrettably, that amounts to a very different animal than focusing on the incorporation of production and technological changes that transform the DNA of the business.

In my view, within the plethora of discussions about the pursuit of mandated ESG disclosures among business associations, policymakers, regulators, standard setters, and activists—indeed, even in the business literature—this equivalence is assumed.

To be blunt, any backslapping, embracing, and handshaking among ESG advocates induced by such disclosure requirements becoming the rule of the day are misplaced—no matter how good they may feel.

This does not mean that such reporting mandates do not have sound objectives. Indeed, they should be pursued. What it does mean, however, is that they are at best an intermediate step for sustainability practices to become integral to a business' operations. A lot can happen along the way to derail such an outcome from becoming a reality. This is exactly what I meant in a recent monthly Forbes column: “Sustainability Is Far More Than Just A Corporate Aspiration.”

One might ask: Is it not out of the question to believe that in some cases, the ESG disclosure commitments required to be reported by businesses may well prove to be in the firms', investors,' workers,' consumers', and society's own best long-run commercial and social interests?

Put another way, what should be the stance of a public policy that requires ESG disclosure even in cases where businesses already undertake such reporting to their stakeholders voluntarily or unilaterally—that is, absent the regulatory mandates—and whose operations in the market are already infused with sustainability practices?

In such instances, it might be tempting to argue that this amounts to a “regulatory burden.” Perhaps, but the strain on such businesses would likely be de minimis. At present, these cases (regrettably) are likely to be rare. We should be so lucky.

What it does mean is that government regulation for mandatory ESG reporting and disclosure should not be monolithic or one-size-fits-all.

At the same time, public officials may well want to give due recognition to such instances so counterpart firms in that sector or firms in different sectors can learn how best-practice operational sustainability is executed.

Arguably, it should not be seen as a heroic feat—nor a naïve one—for the C-suite and the boardroom of the modern corporation to fully embrace and execute sustainability as a core operational mandate of the business for which they are responsible. But let us be clear: mandated ESG disclosures cannot be asymmetric, with firms shining the light only on positive outcomes they have achieved. Such requirements must obligate firms to also detail where business operations led to degradation on those fronts.

What are the Expected Returns from ESG Reporting Disclosures?

What does this mean in practical terms? In my view, pursuit of sustainability entails undertaking operational decisions that lie at the core of a business's day-to-day functions that, taken together, serve to maximise the business's long-run growth as well as assessing their impacts on the firm's long run performance across an array of dimensions, both financial and non-financial.

The emphasis being placed on taken together and long run is key. Firms who are most effective operating sustainably are those who invariably and consistently make their decisions to maximise the long-run commercial and non-economic—that is, ESG-related—returns on the use of their assets, both human and non-human.

If one accepts these propositions, two key insights should leap out.

First, successful attainment of ESG and sustainability goals requires a fundamental understanding that ESG and sustainability are not just matters of engaging in risk mitigation but also of pursuing growth maximisation. In a word, corporate executives, board directors, and investors must think of ESG and sustainability initiatives as opening new doors of opportunity for business growth, not as constraints to abide by with as little effort as needed to fulfill them.

Second, truly embracing sustainability means that C-suite executives and board directors carry out their missions through an integrative lens, one that cuts across a business' principal functions, its markets, both on the input and output sides, and its geographic footprint.

Thus, the firm's Chief Sustainability Officer (CSO) should be in the C-suite working closely with the CEO, and his or her role should be truly a globally integrated one—in every sense of the word: across product and input markets as well as across geographic markets. It is not too far-fetched to think of the role of the CSO as the "Integrator-in-Chief."

So, too, should be the role of boards' sustainability committees, which, unfortunately, are seen as novelties in the boardroom. Indeed, we in the U.S. are far away from an SEC requirement for public company boards to have directors who are “qualified sustainability experts,” akin to the SEC rule for boards to have “qualified financial experts,” engendered by the Sarbanes-Oxley statute coming out of the financial crisis of 2007–2008.

Conclusion: Sustainability Disclosure Requirements Are Necessary but Not Sufficient

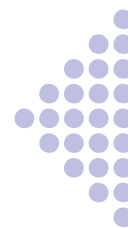
Mandates for ESG reporting and disclosure are not substitutes for businesses engaging in meaningful actions to enhance the sustainability of their operations through enterprise transformation.

To this end, here are four items requiring attention:

- **Harmonisation** of the different sets of existing sustainability standards and reporting requirements around the world should be placed high on the agenda.
- C-suite executives and boards of directors must fashion the systemic integration of businesses' financial and “non-financial” metrics and performance—each of which are critical elements of the lifeblood of the modern corporation and the ecosystem in which it operates.
- The global **development and education of qualified professionals** who are expert practitioners in the monitoring and evaluation of businesses' progress in enhancing operational sustainability should be a priority. The skills and hands-on experience required for these functions differ markedly from those necessary to conduct financial audits. Financial audits centre on retrospective evaluations, whereas assessing progress in achieving sustainability is necessarily both **retrospective** and **prospective**. At the same time, in contrast to conducting financial audits, an interdisciplinary set of skills is required for appraising the systemic integration of sustainability into business functions.
- There is a need to establish an independent, **dispassionate global forum** to foster the cross-border exchange of ideas,

learning from one another, and forming consensus on ways to discharge common critical tasks for monitoring, evaluating and discharging the operational integration of sustainability into business functions. Such a forum should be multilateral, multinational, and cut across industry sectors and be comprised of business executives and board directors; sustainability standard setters and regulators; sustainability experts and practitioners steeped in sustainability evaluation and monitoring; financial auditors; investor, environmental, labour social, and consumer interest groups; among others.

***Dr. Harry G. Broadman** *is Managing Director at Berkeley Research Group LLC, a global expert witness and management consulting firm, where he chairs its Emerging Markets Practice. He sits on several boards—Strategic Ratings Corporation; The ESG Exchange; and PartnersGlobal—and is a National Association of Corporate Directors (NACD) Leadership Fellow and NACD Faculty Member.*



Institute of Directors, India

BRINGING A SILENT REVOLUTION THROUGH **BOARDROOM**

Membership

Training

Masterclass for Directors
leading to **'Certified Corporate Director'**

Golden Peacock Awards

Organization for Non-Executive Independent Directors

Conferences

Board Research & Advisory

MSME Division

Publications

S H A R E • L E A R N • N E T W O R K

www.iodglobal.com

INSTITUTE OF DIRECTORS
M-56 A, Greater Kailash, Part - II (Market), New Delhi - 110048, India
Board Nos.: +91- 11- 41636294, 41636717, 41008704
Fax: +91- 11- 41008705 • Email: info@iodglobal.com

follow us on

@iodglobal