Measuring what Matters

The scramble to set standards for sustainable business
If there is any truth to the adage that “you can’t manage what you don’t measure”, then the biggest revolution in business for 50 years will not fulfil its potential without new metrics.

When economist Milton Friedman was in his pomp and shareholder returns were all that mattered, establishing how a company was doing was pretty simple — at least once the hard work of thrashing out international accounting standards had been done.

Now that stakeholder capitalism has elbowed aside the single-minded focus on investors, however, things have become more complicated. How should we assess a company’s impact on the environment, its employees or its supply chain? And with most investors having accepted that environmental, social and governance factors affect their returns, what data should they be demanding?

As Sarah Murray explains in our second Moral Money Forum report, finding answers to those questions is no less challenging — or vital — than it was when the task was agreeing on international financial reporting standards.

The proliferation of ESG metrics and reporting frameworks in recent years has left executives and investors complaining about the difficulty of keeping up with so many apparently clashing standards — or even remembering what the different acronyms stand for. But this year is shaping up to be a pivotal one for efforts to simplify the “alphabet soup” of ESG reporting.

When we asked FT Moral Money readers for their input to this report, there was scepticism about whether current frameworks were truly measuring companies’ impact on people or the planet. “Our internal standards are all PR,” one told us.

One theme, though, came out strongly: the need to focus on “materiality”, or what matters most to companies’ financial performance, as well as to society and the environment.

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Andrew Edgecliffe-Johnson
US Business Editor,
Financial Times

Quick Read

• Two decades after financial reporting went through a seismic shift with the agreement of international accounting standards, a similar effort is under way to agree global standards for measuring sustainability.

• Companies and investors frustrated with the “alphabet soup” of rival ESG measurement initiatives are pressing for simplification.

• Questions remain over how the proposed framework will fit with others, how many countries will adopt it and whether one standard can apply to all industries.

• Current ESG rankings vary so widely in their methodology that companies have been able to “cherry pick” the most flattering providers.

• The new focus is on “double materiality”, or what matters most to companies’ financial performance, as well as to society and the environment.

• The pandemic has added urgency and a sense of optimism to the search for common standards, with a new mood of collaboration among the largest standard setters and support from leading policymakers.

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The scramble to set standards for sustainable business

Support is growing for common ESG metrics, but their final form has yet to be thrashed out, writes Sarah Murray

In a 2018 speech about the future of corporate reporting, Erkki Liikanen, a former Bank of Finland governor, recalled Europe’s debates over adopting the International Financial Reporting Standards almost two decades earlier. “It was becoming increasingly clear that different accounting requirements of differing quality were adding cost, complexity and risk to companies and investors,” he told delegates at a European Commission conference.

Liikanen, who chairs the trustees of the IFRS Foundation overseeing international accounting standards, could just as easily have been describing what has become known as the “alphabet soup” of acronym-heavy measurement and reporting standards surrounding ESG (environmental, social and governance) approaches to business and investment.

Yet, after years of complaining about the proliferation of competing metrics, companies and investors are beginning to hope that more consistency in measurement and disclosure is in sight. “This is emerging as we speak,” says Kirsty Jenkinson, head of sustainable investment and disclosure at the IASB. “It feels like there’s a better direction of travel, but it will be interesting to see how this next phase is going to play out.”

That phase is unfolding rapidly. Last September, five leading independent standard setters announced that they would work together towards a comprehensive corporate ESG reporting system. Earlier this year, rules came into effect in Europe to make financial firms and investors disclose “double materiality”, which covers the risk that their operations pose to society and the environment as well as to their profitability.

And while it will add another acronym to the mix, all eyes are on the IASB Foundation, which is on track to launch a global Sustainability Standards Board at the UN’s COP26 climate summit in November with the backing of the International Organization of Securities Commissions (IOSCO), the umbrella group for global markets watchdogs.

“What you have is a massive acceleration in a very short period of time — pretty much 12 months of a real willingness and ambition to sort all these problems out,” says Ashley Alder, the chair of IOSCO and chief executive of the Hong Kong Securities and Futures Commission.

Even so, the idea of standardised ESG reporting remains highly contested. Companies argue that the unique nature of their operations will make comparisons difficult — just as they did at the launch of the IFRS and the generally accepted accounting principles, or GAAP. “Nobody is ever happy with a standard by a giant compromise,” says Bob Eccles, a professor at Oxford University’s Said Business School and an expert on sustainability. “What you have with accounting is a social construct and an agreed-upon definition of reality that we all start from — that’s where we’re at with ESG.”

Some crucial questions still have to be settled. Can sustainability measurement and reporting standards serve not only companies and investors but also people and the planet? Can a framework for reporting on climate change — the SSB’s first priority — be applied to complex social issues while enabling comparisons across different sectors and jurisdictions? Can a global standard operate alongside the many existing ratings systems? And how many national governments will adopt it?

Yet the fact that these questions are being raised at all is a sign of progress. And as chief executives and investors set increasingly ambitious social and environmental goals, measuring what matters is something they can no longer afford to ignore.

“Sustainability disclosure is now at the top of the agenda for the world’s largest investors, the world’s largest companies and regulators in almost every major market,” says Janine Guillot, chief executive of the Sustainability Accounting Standards Board (SASB). “That’s a sea change from where this conversation was even five years ago.”

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FT Moral Money

than three-quarters of respondents to our ratings system, the current measurement and reporting

Global Advisors has its R-Factor scoring system, while evaluation and ratings systems. For example, State Street

of consistency across those data sets,” one executive told [greenhouse gas emissions] and the messiness and lack

SustainAbility found that 65 per cent of investors survey ESG ratings at least weekly — the same cannot

In fact, the two providers gave different assessments of Wells Fargo, the manager, reached a similar conclusion after looking

researchers what their organisations struggled with most when trying to measure social and environmental impact, responses included worries that current methodologies allow companies to “cherry pick how they’re assessed” or even to “game” ESG rankings.

They found that scoring variations for social and governance ratings led to the first provider giving the bank a much better overall result than the second. In fact, the two providers gave different assessments for every single ESG dimension except the company’s environmental score.

While demand for ESG ratings products is high — according to consultancy SustainAbility.

companies to “cherry pick how they’re assessed” or even to “game” ESG rankings.

Researchers Feifei Li and Ari Polychronopoulos, who work for Research Affiliates, a Californian investment

Alder of Iosco, “which we eventually spun off as Y Analytics.

For those without the resources to develop an in-house ratings system, the current measurement and reporting

landscape can be frustrating and confusing. In fact, more than three-quarters of respondents to our FT Moral Money

questionnaire thought there were too many different measurement standards.

The journey towards more rigorous ESG measurement and disclosure began in the late 1990s. In 1997, the Global

Reporting Initiative (GRI) launched as a non-profit organisation offering sustainability-focused reporting

guidance. At the time, when a PR-heavy “corporate social responsibility” report was the principal vehicle for disclosing sustainability information, few imagined how many frameworks, ratings systems and standard setting organisations would emerge from the sensible desire to find a more rigorous way of measuring companies’ social and environmental impact.

GRI has since become part of a “big five” group of global standard setters along with CDP (formerly the Carbon Disclosure Project), the Climate Disclosure Standards Board (CDSB), the International Integrated Reporting Council (IIRC) and SASB.

Rather than develop standards, the Task Force on Climate-related Financial Disclosures (TCFD) has meanwhile provided a framework on which others can build. Created by the Financial Stability Board, the rulemaking body set up after the financial crisis, its focus is climate change.

But Mary Schapiro, head of the TCFD secretariat and former chair of the US Securities and Exchange Commission, argues that its work could be applied more broadly. “When we created the TCFD framework, we based it on a foundation that would be familiar to companies that have to report on these kinds of risks,” she says. “So we have four pillars of disclosure: governance, strategy, risk management and targets and metrics. And those four pillars work for any ESG issue.”

So far, more than 3,000 organisations have expressed their support for the TCFD’s recommendations, including companies with a collective market capitalisation of almost $26tn and financial institutions responsible for $175tn worth of assets.

Nevertheless, companies and investors can be forgiven for still feeling confused. “There has been a lot of noise in the system,” says Alder of losco, “which is not surprising given that the demand from investors is high while the ability of issuers — asset managers and others — to provide the information is genuinely technically difficult.”

While demand for ESG ratings products is high, the same cannot always be said for their quality

Companies are dealing with hundreds of different ESG regulations, codes and standards around the world

The R-Factor pulls together best-in-class data sources

When State Street Global Advisors surveyed the ESG measurement and reporting landscape three years ago, its
dominant impression was one of confusion. “There were a number of different scoring methodologies for ESG but they had wildly different approaches and that led to wildly different results,” says Lori Heinel, SSgA’s global chief investment officer.

As a result, the company decided to develop its own scoring system, the R-Factor – it stands for responsibility. It also recognised that, given the work others had done in this field, starting from scratch made no sense. “Rather than reinvent the wheel, we decided to take best-in-class data sources and bring them together,” says Heinel.

Launched in 2019, the R-Factor draws on data from four leading providers and uses SASB’s materiality framework to generate ESG scores for more than 6,000 listed companies globally. “An R-Factor score is intended to be a compilation of best-in-class data sources to get more of a transparent, comparable, concise measure of a company’s ESG footprint,” says Heinel.

However, she argues that ratings alone do not always provide the full picture of that footprint. “Part of the value in R-Factor is it gives us the basis for a conversation with a company about what material factors they are reporting and how timely and comprehensive that reporting is,” she says. “Because one of the reasons you might have a poor R-Factor score is because the data is not just there or is stale or incomplete.”

Given the speed at which ESG ratings developments are unfolding, she stresses that the R-Factor is a “bridge strategy” that may have a limited lifespan. “It’s our hope and expectation that 10 or 20 years from now we won’t talk about ESG as its own standalone thing. It will be like the financial accounting standards,” she says. “So we would not be disappointed if at some point in the future the R-Factor was no longer necessary.”
The materiality challenge

As Alder points out, coming up with the right ESG data is no easy task, but those working on the ESG measurement and disclosure challenge are converging on a principle they call “materiality.” For until companies have figured out which social and environmental factors really matter to their business, they cannot accurately assess their ESG or sustainability performance.

Companies also need to be able to evaluate the “circularity between impact and dependencies”, says Veronica Poole, Deloitte’s lead expert on IFRS accounting rules. This means assessing how their footprint affects not only the broader society but also the company. An example might be a drinks company whose water consumption reduces the supply for both local communities and the business itself.

“Understanding that circularity is critical, and you can’t just look at the next 12 months,” says Poole. “You need to look to the longer term and across the entirety of your value chain — that’s a different way of approaching materiality from the current financial materiality thinking when it comes to financial statements.”

Measuring what matters is also something with which investors struggle when constructing sustainable investment portfolios. In SustainAbility’s Rate the Raters survey, greater focus on materiality ranked second — after improvements in disclosure methodologies — among the changes to ESG ratings investors said they would most like to see in the next five years.

An added complication is that what is material to one business may be less relevant to another. While fuel efficiency, for instance, is a significant factor in an airline’s financial and sustainability performance, the same would not be true for a legal services firm.

Moreover, what matters to companies can change rapidly. As the movement achieved scale globally, companies are asked to report on “double materiality” — the effect sustainability issues have not only on companies’ financial performance and long-term value but also on society and the environment. Lenders and investors are interested in the former, while employees, customers, civil society organisations and a range of regulators want data on the latter. “So when you talk about sustainability disclosure, it’s important to be clear on the target audience,” says SASB’s Guillot.

Jenkinson of Calpers sees a regional divide emerging. “You have this bifurcation where Europe, the GRI and other standard setters are pointing to the impact that business has on society, whereas in the US, where it will be really challenging to shift the emphasis, it’s going to be the risk to an investor from a company’s ESG factors,” she says. “That’s perhaps adding to the confusion on sustainability standards.”

Moreover, what matters to companies can change rapidly. Take the #MeToo movement. In 2017, with accusations of sexual assault being levelled at US film producer Harvey Weinstein, a tweet by actress Alyssa Milano calling on harassment survivors to tweet about their experiences on the #MeToo hashtag went viral.

As the movement achieved scale globally, companies started reviewing their gender equity policies while capital flows into “gender lens” investments swelled to $1.4bn in assets under management by 2018.

The #MeToo movement provides a powerful illustration of why companies and investors need to be able to measure ESG not only by looking backwards to past performance, but also by anticipating what social or environmental factors are likely to matter in the future.

ESG must also be measured by anticipating what social or environmental factors are likely to matter in the future.
If there are similarities between the development of international accounting standards and current progress on ESG measurement and disclosure, one big difference is proving an advantage: the sense of urgency.

“The pandemic has concentrated minds,” says Alder. “What were seen to be remote existential risks may not be all that remote,” This, of course, includes climate change and a growing sense that action is needed now to avert a planetary crisis. “On the climate side, we don’t have much time,” he says. “We don’t have the luxury of 10 to 15 years to produce a standard.”

What the IFRS Foundation and Iosco do have, however, is infrastructure — something developed two decades ago for the international accounting standards. “We have IFRS, we have the governance model,” says Erik Thédeén, director-general of Finansinspektionen, Sweden’s financial regulator, and chair of Iosco’s sustainable finance task force. “So what we’re doing is building a parallel governance structure inspired by the financial part of it — that, of course, makes it easier.”

A new spirit of collaboration among standards setters will help. While the big five are already planning to streamline their reporting standards, two other standards-based organisations, B Lab and the Global Impact Investing Network (GIIN), are also working to align their impact measurement tools. And in March, the World Economic Forum’s International Business Council, which had its own ESG reporting framework in the works with the Big Four accounting firms, announced that it would hack the SSB.

And while the plethora of standards has been a source of frustration, it has allowed the IFRS Foundation and Iosco to move faster than they might otherwise have done. “We already have the standards with TCFD and with the other private standard setters merging and working together now,” says Thédeén. “So we don’t need to find a new system — it’s more like refining the metrics and the definitions we already have.”

Technology could also play a role, with machine learning and artificial intelligence able to tap into everything from traditional corporate reporting to alternative data ranging from satellite imagery, social media, news and analysis to remote sensing. “It enables the democratisation of ESG data and more tailored solutions,” says Georg Kell, chair of Arabesque, a quantitative asset manager which uses AI and big data to assess the ESG performance of globally listed companies. “The costs of doing so have come down and the ability to create bespoke solutions is improving enormously — that’s the next wave on the investment side.”

Noises from governments also favour the streamlining of ESG measurement and reporting. In the US, Joe Biden’s administration has put the task of combatting climate change back on the agenda, adding fresh impetus to ESG disclosure efforts.

John Coates, acting director of the SEC’s division of corporation finance, said in March that the agency should “help lead the creation of an effective ESG disclosure system so companies can provide investors with information they need in a cost effective manner.”

Policymakers elsewhere are also becoming more active, with Jacinda Ardern’s government announcing that New Zealand plans to become the world’s first country to make climate risk reporting mandatory, using the TCFD framework. Guillot sounds a note of caution, however. “A topic like greenhouse gas emissions, where there’s been a global greenhouse gas protocol to develop global consensus around measurement, is significantly more advanced than, let’s say, a topic like diversity,” she says. “Even with the concept of standards, there’s still significant complexity in measurement because of the nature of the issues.”

## Conclusion

Given the forces lining up in support of sustainability accounting standards, levels of optimism are high. “Two years ago, when Iosco started looking into this and sending questionnaires to stakeholders, it was very premature to talk about where we are right now,” says Thédeén. “So we are all positively surprised.”

And because the SSB is focused on reporting, Alder believes governments will be open to adopting its set of standards. “We’re not taking a policy stance,” he says. “This is more to do with the standards around which reporting should happen so that asset owners and asset managers can make better capital-allocation decisions. From that perspective it’s eminently adoptable.”

This does not mean the work on ESG measurement and disclosure is over — far from it. While respondents to the FT Moral Money questionnaire were unanimous in agreeing that companies should measure their social and environmental impact, a large group of passionate experts is now seen as a necessary tool in shifting capitalism towards a more sustainable model. As Eccles puts it, “if you put ESG information on par with financial systems, with the same quality of control systems, the same quality of assurance, the same rigour and enforcement — that’s a game changer.”

## Two thirds of investors use ESG ratings at least once a week

**ESG ratings use frequency**

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Very regularly (multiple times a week)</td>
<td>35%</td>
</tr>
<tr>
<td>Regularly (at least once a week)</td>
<td>30%</td>
</tr>
<tr>
<td>Sometimes (at least once a month)</td>
<td>13%</td>
</tr>
<tr>
<td>Rarely (a few times a year)</td>
<td>17%</td>
</tr>
<tr>
<td>Never</td>
<td>4%</td>
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Source: SustainAbility (March 2020)

## Investors want more of a focus on ‘materiality’ as well as quality

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<th>Preferred changes and solutions for ESG ratings to better serve companies, investors, and other stakeholders in next five years (% of responses)</th>
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<tbody>
<tr>
<td>1st option</td>
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<tr>
<td>----------------</td>
</tr>
<tr>
<td>Improved quality and disclosure of methodology</td>
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<tr>
<td>Greater focus on relevant/material issues</td>
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<tr>
<td>Better linkage to company financial performance</td>
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<tr>
<td>Greater consistency and comparability across rating methodologies</td>
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<tr>
<td>Consolidation of ratings</td>
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<td>Greater engagement of rated companies in the evaluation process</td>
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<tr>
<td>Other</td>
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Source: SustainAbility (March 2020)
Do Standards for Sustainability Reporting need to be mandated?
Robert G. Eccles, HMI Advisor, Said Business School, University of Oxford

Let’s be clear about mandated standards for financial and sustainability reporting, especially what they are and what they are not.

Standards are a social construct. They are a consensus about how to represent a company’s performance. They are a baseline for analysis and dialogue that can be supplemented in many ways.

They are not, however, a perfect scientific solution that stifles debate.

Reporting standards are imperfect and must be viewed as a basis for contention and evolution. As such they are frustrating but essential. They level the playing field for both companies and investors.

One argument against sustainability reporting standards is that they do not capture the uniqueness of a company. The same is said about accounting standards. There is some truth in this assertion but the effect is exaggerated.

Standards are inevitably imperfect but they do enable comparability, which benefits both companies and investors. Reporting to a set of standards does not stop a company from providing additional information – and in fact most do.

The controversial “non-GAAP” earnings measures in accounting is one example. Another instance is how companies voluntarily disclose information in their quarterly calls and investor meetings that is not required, such as revenue and earnings by product line and market share.

So should the application of standards be voluntary or mandated? Here governments can be weak or strong in their approach.

In the former, a government endorses a set of standards but does not require companies to report against them.

This is similar to St Augustine’s plea: “O Lord, make me chaste – but not yet.” In such a situation, companies may choose to report in some other way or not report at all, and the benefit of comparability and having information from all listed companies, so essential to investors, is lost. Standards, therefore, are most effective if they are mandated.

Today the best hope for a global set of standards for sustainability reporting is the Sustainability Standards Board (SSB), which is being established by the IFRS Foundation under the direction of its private and public sector trustees.

To varying degrees governments around the world, including the US and those in the EU, have indicated support for the SSB. This is positive but far from sufficient.

If the EU eventually decides to mandate its own reporting standards through its Non-Financial Reporting Directive, the hope for global standards will be lost. If the US endorses standards set by the SSB but makes them voluntary – as is the case with US GAAP versus the International Financial Reporting Standards – then that is better than setting up its own standards.

Establishing a base set of global sustainability reporting standards that governments and institutional investors can mandate or require to be used would be an enormous step forward, albeit still an uncertain one.

This, though, is necessary if we are to shift capital allocation decisions so that they support a stable long-term economy and society, and a natural environment conducive to both.

For this to happen, performance targets have to be set, such as being net-zero by 2050 in greenhouse gas emissions. Standards have nothing to do with target-setting. Without standards, however, there is no way to compare a company’s performance over time or its performance in relation to its peers.

*High Meadows Institute’s views are separate from other advisory partners, the FT and the FT Moral Money Forum.
Regulating ESG
The glut of reporting systems, frameworks and rating agencies causes confusion for both ESG watchers and participants and we need to achieve a greater alignment of expectation, disclosure and approach.

Is more legislation the answer? Regulation and better standards are on the way as a result of initiatives by both government and the private sector. Calls are increasing for mandatory disclosure.

Sector initiatives
Initiatives to try to standardise ESG reporting have emerged organically in several sectors. There is no doubt that peer participation encourages a race to the top but there is concern over equality of application, and achieving a level playing field will be crucial.

While voluntary initiatives encourage compliance, the risk is that companies could be benchmarked against peers whose operations are subtly different or that do not have the same level of disclosure.

Regional frameworks
In some industries existing regulatory frameworks have been extended to take in these organic initiatives. One example is financial services where institutions are increasingly expected to focus on ESG-related disclosures in their filings.

The pressure for this is becoming intense. In February Allison Herren Lee, the acting chair of the US Securities and Exchange Commission, directed the Division of Corporation Finance “to enhance its focus on climate-related disclosure in public company filings”.

She also said it must update its climate change disclosure guidance, which dated back to 2010.

Lee later confirmed that the SEC had “begun to take critical steps toward a comprehensive ESG disclosure framework”.

Regional regulation
Other regional initiatives include the EU regulation on sustainability-related disclosures in the financial services sector. This sets transparency requirements and directs companies to make a risk assessment as part of their investment analyses.

The bloc also has plans for enhanced disclosure in non-financial sectors, as well as mandatory due diligence to cover human rights, environmental issues and governance.

Many industries have cautioned against a standard that reduces flexibility. In this regard, legislation that adopts indicative measurements may help address the concerns, especially across sectors and with businesses of varying sizes.

A “one size fits all” approach tailored to any one region is unlikely to work given the global nature of business. Worldwide harmonisation may be an ideal but it is not an immediate solution.

Covid-19 has put ESG in the spotlight – where it is likely to stay. But the potential weaknesses in measurement and reporting, together with the possibility of exploitation and manipulation, highlight that it is not just individual companies’ ESG credentials that are under scrutiny. More work is needed on the self-regulation of the “ESG industry” itself.

The UK Competition and Markets Authority’s current investigation into alleged greenwashing by ESG rating agencies is an important step in trying to bring order and structure to the industry.

In our view it is inevitable that regulation of ESG standards will follow.

*White & Case’s views are separate from other advisory partners, the FT and the FT Moral Money Forum

About the FT Moral Money Forum

The FT Moral Money Forum takes key issues from the ESG debate and explores them for FT Moral Money subscribers.

The forum highlights the macro and philosophical questions and explores the experiences and solutions being proposed. We apply an editorial filter to these and present the most interesting ideas and experiences. We also engage our data visual team to find the best form of presentation.

The forum produces regular reports to highlight the ideas, policies and practices that are making a difference.

Find how to take part in the FT Moral Money Forum by emailing michael.hepburn@ft.com