

Environmental, Social and Governance (ESG) Why the "G" Matters Too?



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In November 2021, the International Sustainability Standards Board (ISSB) launched the first two prototypes of sustainability disclosure standards in financial matters, to provide investors and financial markets with information on the risks and opportunities that sustainable development generates in the operations of the companies. It is expected that in the first months of 2023, these prototypes will become definitive standards, having already considered the international feedback received during the first half of 2022.

The first prototype deals with the general requirements for the disclosure of financial information related to sustainability. The second, on the disclosure related to the climate, this being a very important element within the environmental sphere due to the risks and impacts that it implies at a global level.

It is in this financial sustainability disclosure that we find the increasingly famous acronym "ESG", used when organizations measure, identify and quantify their impacts and practices in the three spheres of sustainable development¹.

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How then to unite corporate management, corporate governance or governance with environmental and social impacts for the creation of long-term value for all stakeholders, including shareholders? In other words, how does the "G" participate in sustainability?

¹ Sustainable development is defined as the ability to meet the needs of present generations without compromising the ability of future generations to meet their own needs in three areas (social equity, environmental protection and economic growth).

Dimensions and Sustainability Issues from SASB²

On March 31, 2022, the ISSB confirmed the plans to develop sustainable standards, using as a basis those of the Sustainability Accounting Standards Board (SASB)³, an organization that merged with the former last July.

SASB identifies 26 general sustainable issue categories grouped into five dimensions, under which it elaborates the disclosure topics and respective metrics for each of the 77 industries in which it identifies a specific sustainable profile.

Disclosure topics are industry-specific, tailored versions of sustainable topics that are reasonably likely to have a material financial impact on companies participating in an industry.

Sustainability accounting metrics are quantitative or qualitative indicators created to measure performance in each disclosure topic.

The list of dimensions and issues is as follows:

Dimension	General Issue Category (Sustainability Issue)
Environmental	<ul style="list-style-type: none"> • GHG Emissions • Air Quality • Energy Management • Water & Wastewater Management • Waste & Hazardous Materials Management • Ecological Impacts
Social Capital	<ul style="list-style-type: none"> • Human Rights & Community Relations • Customer Privacy • Data Security • Access & Affordability • Product Quality & Safety • Customer Welfare • Selling Practices & Product Labeling
Human Capital	<ul style="list-style-type: none"> • Labor Practices • Employee Health & Safety • Employee Engagement, Diversity & Inclusion
Business Model & Innovation	<ul style="list-style-type: none"> • Product Design & Lifecycle Management • Business Model Resilience • Supply Chain Management • Materials Sourcing & Efficiency • Physical Impacts of Climate Change
Leadership & Governance	<ul style="list-style-type: none"> • Business Ethics • Competitive Behavior • Management of the Legal & Regulatory Environment • Critical Incident Risk Management • Systemic Risk Management

² Sustainability Accounting Standards Board

³ <https://www.ifrs.org/news-and-events/news/2022/03/issb-communicates-plans-to-build-on-sasbs-industry-based-standards/> accessed December 2022.

This article elaborates on the Leadership and Governance dimension, finding that SASB aims to disclose issues related to governance at an operational level that is not measured, and therefore reports on a regular basis as traditional governance management does. For clarity purposes, SASB identifies the challenges and pressures that in the business model or industry practices may come into conflict with the expectations of stakeholder value creation, versus the search for only optimizing short-term benefits for shareholders, which may go to the extreme of hindering the social license to continue operating.

SASB bases its standards on the concept of financial materiality, i.e. it identifies sustainable topics that may have a material impact on the organization's finances. In other words, for SASB a topic is financially material if, by omitting, misstatement or obscuring it, could reasonably be expected to influence the investment or lending decisions that users make based on their assessments of financial performance and business value in the short, medium and long term.

In the following, we will provide an analysis of each sustainable theme related to leadership and governance based on the SASB standards⁴ :

1. Business Ethics.

The ethical conduct of an organization presents opportunities and risks. Activities such as bribery, fraud, corruption, entail additional costs and even possible fines that result in the erosion of business value. To preserve it, policies and procedures must be implemented to avoid conflicts of interest, acts of negligence or unintentional errors. Employee training becomes critical.

This issue **does apply** to large companies as well as to family-owned companies, which tend to be small and medium-sized.

The following table shows the disclosure topics that SASB standards present for 2 industries. This example sheds light on the nuances that this topic has in each of them:

⁴ SASB standards are available on its website <https://www.sasb.org/>.

Industry	Real Estate Services	Casinos and Gaming
Sustainable Theme	Business Ethics	Business Ethics
Disclosure Topic	Information and transparent management of conflicts of interest	Internal controls on money laundering
Sustainable Accounting Metric	Brokerage income from dual agency transactions ⁵	Description of anti-money laundering policies and practices. Total amount of monetary losses as a result of legal proceedings related to money laundering

As can be seen, this information gives a better understanding of corporate management and allows a glimpse of the robustness of risk management and internal control, as well as the possible financial impacts, as in the case of casinos and gambling.

On the other hand, family businesses can base business ethics on this sustainable issue by relying, for example, on Article 25 of the Mexican General Law of Administrative Responsibilities regarding Integrity Policies, which covers seven elements and from which other relevant metrics can be derived to measure performance:

Organization and procedures manual	Appropriate control, surveillance and audit systems	Code of Conduct	Whistleblowing systems	Training systems and integrity instruction	Policies to avoid the incorporation of risky people	Transparency mechanisms
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In other words, the SASB topics and examples serve as a starting point for small and medium-sized companies to find ideas and "fit" when analyzing SASB standards as presented in the preceding paragraph.

⁵ Dual agency is defined as those in which the entity represents both the buyer and the seller in the same real estate brokerage transaction.

2. Competitive Behavior.

Certain industries are exposed to monopolistic issues which can result in inefficient services and high prices. Poor management can result in fines, lawsuits, reputational damage and constant competitive review.

This issue is particular to specific industries and large companies. A table is presented with examples of organizations that may be found to be engaged in monopolistic practices:

Industry	Oil and Gas - Refining	Software and IT Services
Sustainable Theme	Competitive Behavior	Competitive Behavior
Disclosure Topic	Price transparency and integrity	Intellectual property protection and competitive behavior
Metric (Accounting Parameter)	Total amount of monetary losses as a result of legal proceedings related to price fixing or price manipulation	Total amount of monetary losses as a result of legal proceedings related to unfair competition rules.

3. Management of the Legal & Regulatory Environment.

Organizations that are at the forefront in the creation of new products or services often interact with regulators and legislators. Sometimes the agreements reached may have social and environmental impacts; for this reason it should be disclosed whether government incentives are received, whether lobbying actions have been taken to influence the industry's legal policies and measure whether the company has the capacity to comply with laws and regulations by reporting the imposition of fines with amounts and reasons, among others.

Therefore, this sustainable issue is material for large companies such as those mentioned in the following example:

Industry	Biofuels	Chemicals
Sustainable Theme	Legal and Regulatory Environment Management	Legal and Regulatory Environment Management
Disclosure Topic	Management of the legal and regulatory environment	Management of the legal and regulatory environment
Metric (Accounting Parameter)	<p>Amount of subsidies received through government programs</p> <p>Analysis of corporate positions related to governmental regulations or policy proposals that address environmental and social factors affecting the sector.</p>	<p>Analysis of corporate positioning related to governmental regulations or policy proposals that address environmental and social factors affecting the sector.</p>

Notwithstanding the above, family businesses can monitor and establish similar metrics by identifying applicable laws, rules and regulations. Schools, fintechs, food processing, to cite a few examples, even if they do not have lobbying activities or influence, they are subject to various regulations of which they should be aware.

4. Critical Incident Risk Management.

Due to the nature of the activity and business model, certain organizations must manage health and safety risks in a very robust manner. Failure to do so can have dire consequences for the environment, employees and workers, as well as nearby communities. The damage and loss of assets can be severe, as can the costs inherent in crisis management and reputational impact. To put in context, nuclear plant incidents, while unlikely, have proven to be brutal to the environment and society.

The following table again shows two examples of industries where SASB identifies material financially relevant issues, and therefore the need for disclosure to enable the interested party to make a judgment about the management of the board of directors and senior management:

Industry	Metals and Mining	Road Transportation
Sustainable Theme	Critical Incident Risk Management	Critical Incident Risk Management
Disclosure Topic	Tailings storage facility management ⁶	Accident and safety management
Metric (Accounting Parameter)	<p>Tailings Storage Facility Inventory Table: (1) facility name, (2) location, (3) ownership status, (4) operational status, (5) method of construction, (6) maximum permitted storage capacity, (7) current quantity of tailings stored, (8) consequence classification, (9) date of most recent independent technical review, (10) material findings, (11) mitigation measures.</p> <p>Summary of tailings management systems and governance structure used to monitor and maintain the stability of tailings storage facilities.</p>	<p>Number of road accidents and incidents</p> <p>Basic percentiles of the safety measurement system for: (1) reckless driving, (2) hours of service compliance, (3) fitness to drive, (4) controlled substances/alcohol, (5) vehicle maintenance, and (6) compliance with hazardous materials standards.</p> <p>(1) Number and (2) total volume of discharges and releases to the environment</p>

⁶ Tailings are a common by-product of the metal and mineral recovery process. In general, it consists of a liquid slurry composed of water and fine particles of metals and minerals. It is created when mined ore is crushed and finely ground in the milling process. <https://www.icmm.com/es/gestion-ambiental/gestion-de-desechos/acerca-de-los-relaves> accessed December 2022.

5. Systemic Risk Management.

Both in the previous topic and in the present one, ESG risk management can be seen as fundamental to achieve business value and avoid the inherent costs when the risk materializes in an event. Awareness of environmental and social impacts, together with the practice of measuring them, makes it possible to identify risks and their possible responses⁷.

Systemic risk is defined here as an event at the level of an organization that can trigger severe instability or collapse of an entire industry or economy⁸. If an entity is systemically important, governance that can reduce its contributions to risks of this nature becomes a priority, and it is very likely that they will be highly regulated.

The costs associated with mitigating these risks are lower than the direct and indirect financial impacts caused by a systemic event.

As expected, this issue is relevant only for large companies in very specific industries such as those discussed in the following table:

Industry	Telecommunications Services	Banks Commercials
Sustainable Theme	Systemic Risk Management	Systemic Risk Management
Disclosure Topic	Management of systemic risks due to technological disruptions	Systemic Risk Management
Metric (Accounting Parameter)	(1) average system outage frequency and (2) average customer outage duration. Analysis of systems to provide unimpeded service during service interruptions.	Global Systemically Important Bank (G-SIB) assessment score, by category. Description of the approach for incorporating the results of mandatory and voluntary stress tests into capital adequacy planning, long-term corporate strategy and other business activities.

Having analyzed the 5 sustainable themes within the "Leadership and Governance" dimension, we note that, although targeted at large companies, simple but effective practices can be identified and implemented for family businesses.

⁷ Responses may be to accept, avoid, pursue, mitigate or share the risk.

⁸ <https://www.investopedia.com/terms/s/systemic-risk.asp> accessed December 2022.

As with any effort of this nature, the executive sponsorship of the board of directors, or owner(s), is critical in order to bring the G of "Governance" to life, and thereby open up to sustainable issues, disclosure topics in the E of "Environmental" and S of "Social".

Not to be overlooked is that many of these sustainable impacts exist, or have repercussions, in more than one of the five dimensions. An example can be found in industries characterized by high levels of innovation, where employee engagement, diversity, and inclusion can affect product design and lifecycle management.

Final Reflections and the Challenge Ahead

The sustainability accounting metrics (as SASB calls them), provide additional information on the actions of organizations in the search to generate business value for their shareholders while incorporating environmental and social practices with their corporate management in this regard, and may have a future or present impact on the financial statements.

One of the conceptual elements that ISSB handles in the new standards is the connectivity of sustainable information with financial information. Disclosure should be made in such a way that users can understand the connections, dependencies and exchanges between both sets of information⁹. In this regard, there is a tendency to produce integrated reports.

Connectivity represents one of the greatest challenges, if not the greatest, so that all stakeholders, be they shareholders, owners, investors, not to mention board members, CEOs and senior management, can become familiar with ESG practices and thereby achieve "integrated thinking"¹⁰ that helps preserve and enhance value for the benefit of all stakeholders and society at large.

⁹ Taken from paragraph 21 of the ISSB's "General Requirements for Disclosure of Sustainability-related Financial Information Prototype" published on November 3, 2021.

¹⁰ The Integrated Thinking Principles are also part of the ISSB as of July 2022. Together with the International Integrated Reporting Framework they are used to connect financial statements with financial sustainability disclosures. For more information visit: <https://www.integratedreporting.org/the-iirc-2/>