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# Seek and you may find

How CFOs can manage sustainability risks and find long-term value in unexpected places

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Environmental, social, and governance (ESG) risks increasingly demand the attention of chief financial officers (CFOs). And while some CFOs continue to believe that ESG topics fall outside their mandate as stewards of financial information, market evidence suggests quite the opposite.

**Increasing expectations for CFO involvement**

Financial executives (e.g., chief financial officers, chief accounting officers, and controllers) will need to be involved in the organization's evaluation of climate-related risks and opportunities and the efforts undertaken to manage the risks and maximize the opportunities.[1]

**Financial Stability Board Task Force on Climate-related Financial Disclosures (FSB TCFD)**

Sustainability disclosure "helps demonstrate transparency and effective management and enhances the company's ability to attract long-term capital and favorable financing conditions." It "generates financial value for the company by identifying opportunities for cost savings, revenue generation, and risk mitigation."[2]

**World Federation of Exchanges (WFE)**

Financial reporting today has not kept pace with both company managers' and investors' interest in broader categories of information that are also material to operations and financial performance.[3]

**Sustainability Accounting Standards Board (SASB)**

I think the natural evolution will be for CFOs to become more deeply engaged in evaluating these issues and whether they could have a material impact on the company's operations and financial situation.[4]

**Former Securities and Exchange Commission (SEC) chairman**

Companies that aren't addressing these issues may be caught flat-footed as these pre-financial risks manifest themselves and become central to business strategy. Consider the following situations:

A beverage company loses access to water due to local water scarcity or loss of social license to operate in surrounding communities.

A technology company fails to listen to its highly skilled labor force. Employee turnover increases and the company loses its competitive advantage.

A consumer products company faces brand and reputational damage and consumer backlash for instances of human rights violations in its supply chain.

After reading these examples, you might be thinking, "I've never considered these risk areas as sustainability risks; they're just business risks." Yes, they certainly are business risks, and that's key to understanding their impact on your long-term financial performance and unlocking potential "hidden value" in your business. They should grab your attention. Consequently, CFOs should advocate sustainable business practices and transparent reporting on how their companies' value is sustained over time.

So what's holding you back? Managing environmental resources can help avoid business interruptions, just as managing your workforce helps to avoid turnover. Furthermore, understanding your supply chain can help reduce the risk of brand damage. As Goldman Sachs has stated, "If you ignore sustainability, you're going to be worth less."[5] If you're beginning to see that there is value from addressing these risks, then read on.

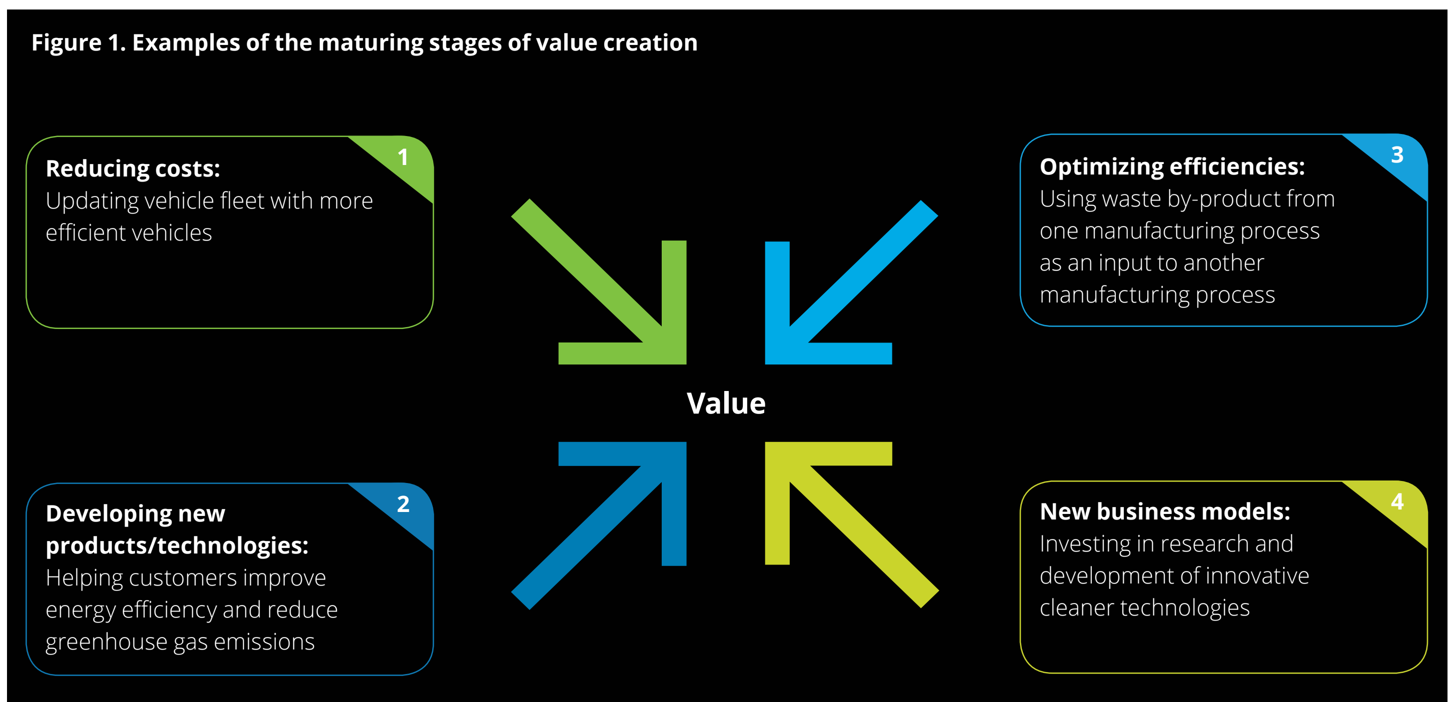
# Where's the value?

The business context for ESG impacts is evolving rapidly and challenging corporate executives to translate global megatrends, such as climate change, resource scarcity, and population growth, into tangible risks and opportunities for their businesses to manage. ESG impacts are generally longer-term in nature and, in many cases, beyond the direct control of a company. This makes the linkage of ESG impacts to business value even more challenging. But methods of accounting for sustainability performance are advancing to meet this challenge. This is where the role of the CFO emerges: At the intersection of sustainability and financial performance, the CFO is in the best position to define and communicate how a company's management of ESG risks contributes to value creation.

Sustainable value can be created in many ways. Pioneering companies often start by focusing on risk and cost reduction. Over time, they develop strategies for increasing value creation, ultimately including intangibles such as brand and culture (Figure 1).[6] Encouragingly, such actions also serve the dual purpose of helping to avoid potential brand and reputation damage that often accompanies sustainability risks.

**When your CFO is well-versed in sustainability, it goes a long way.**

**Figure 1. Examples of the maturing stages of value creation**



# Where to start?

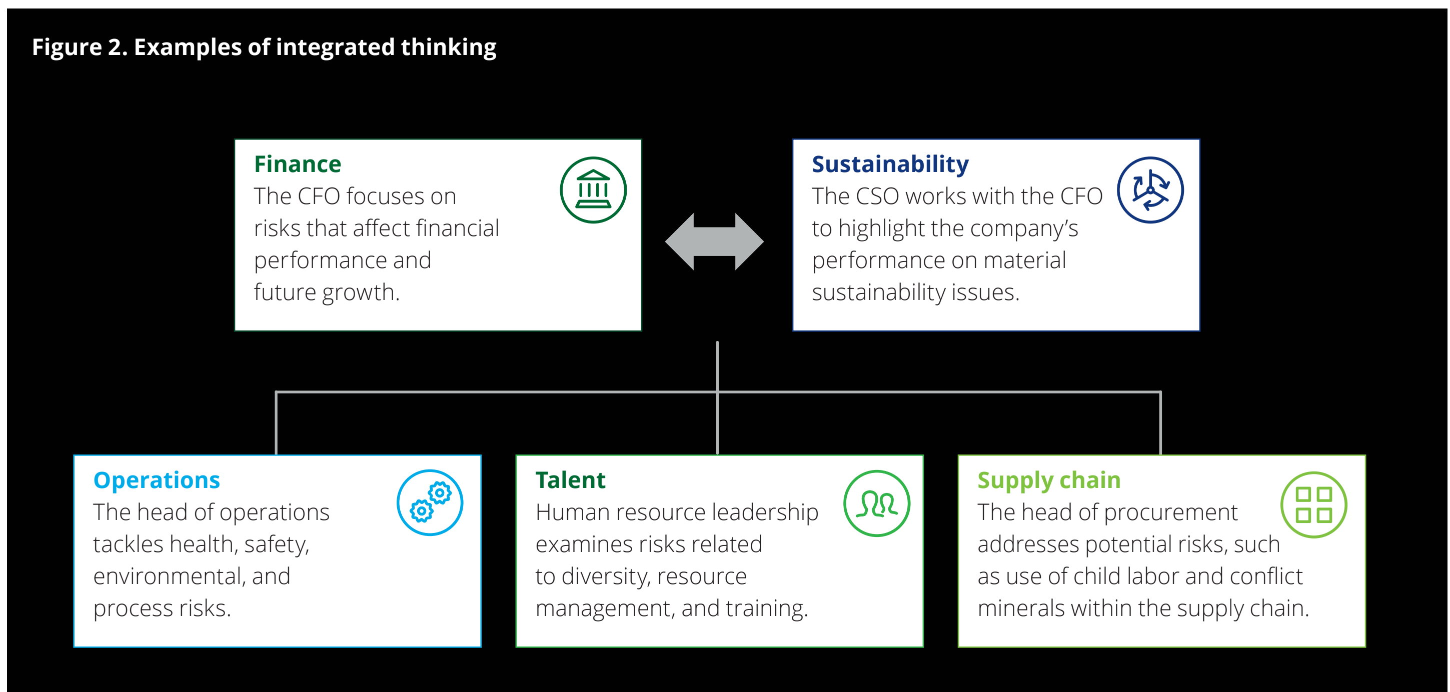
While pressure mounts for businesses to grow the bottom line and be good corporate citizens, sustainability risks can go unrecognized as the opportunities they are, ripe for value creation. Integrated thinking, and specifically promoting greater collaboration between a CFO and a chief sustainability officer (CSO), is necessary to help the company more intentionally take advantage of such opportunities and move beyond a narrow focus on short-term profits.

Here are three actions CFOs can consider to begin addressing sustainability issues:

### 1. Organize internally

Alignment of a company's internal team is important because sustainability and corporate performance are inextricably linked. Addressing material risks (i.e., ESG trends, events, and uncertainties that are reasonably likely to have material impacts on their financial condition or operating performance[7]) requires breaking down silos and engaging in integrated thinking (Figure 2).

**Figure 2. Examples of integrated thinking**



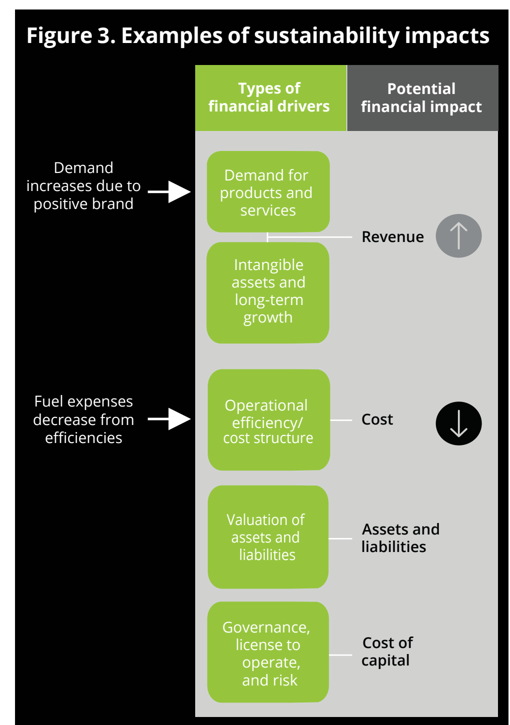
Through a more integrated approach to sustainability risk management, management is better able to understand the interdependency of strategic decisions and allocation of resources to address identified risks and value-creation opportunities related to raw materials, products, processes, operating locations, human capital, and others. Internal coordination of these efforts is essential to avoid missing opportunities and potentially sending mixed signals to the organization and marketplace. Furthermore, it serves to place sustainability within the company's strategic initiatives and move the company toward more mature sustainability-related value creation activities, simultaneously creating a competitive advantage.

### 2. Focus on the material issues

Research indicates that companies that perform well on material sustainability issues and concurrently perform poorly on immaterial sustainability issues enjoy the strongest financial returns. The research also found that 80 percent of disclosures are immaterial, having no correlation to positive performance.[8] Material risks vary depending on the industry, and determining which ESG risks need to be treated as material is an essential step in crafting a sustainability reporting strategy. Material sustainability risks can affect a company's financial statements in a number of ways, having both short- and long-term impacts (Figure 3).

For example, the Sustainability Accounting Standards Board standards for the air freight and logistics industry include a metric on total fuel consumed and percentage renewable, suggesting that fuel management is material to companies in this industry. (The ultimate determination of what is material is for the company to decide.) Recognition of fuel management as a material sustainability issue and incorporation into the company's strategic initiatives can positively affect a company's financial statements in the short term through decreased fuel expenses. In the longer term, decreasing the company's fuel consumption overall and increasing its use of renewables can positively impact the company's brand and potentially drive demand for the company's services from environmentally conscious consumers. The company is also able to reduce carbon emissions, which represent costs in the form of increasing regulation and inefficiency, and mitigate the risks of fuel shortages or spikes in fuel prices.

It's often been said that you can't manage what you don't measure. Armed with insights from monitoring and tracking sustainability metrics, company leaders can manage sustainability performance and report using a robust, data-driven narrative that describes future value-creation potential.



### 3. Tell your story

Recent developments, both in the United States and internationally, demonstrate the heightening sustainability focus among investors, companies, and policy makers. Even under the new US administration, the marketplace momentum demonstrates that the ESG agenda for corporate preparers is only intensifying. These developments should be a wake-up call to CFOs and other C-suite executives about the potential risks of inaction:

**Recent developments**

- Financial Stability Board Task Force on Climate-related Financial Disclosures – Coming from the Paris Agreement, the FSB TFCD developed recommendations for voluntary climate-related financial disclosures aimed at providing useful information to lenders, insurers, and investors.
- Securities and Exchange Commission – While only 4 percent of the concept release published in April 2016 addressed sustainability disclosure, 66 percent of non-form comment letters discussed the topic.
- World Federation of Exchanges – More than 85 percent of respondents to WFE's 2016 Exchanges and Sustainability survey require some form of ESG disclosure in their markets.
- World Economic Forum – Four of the top five risks in terms of impact are environmental per the WEF's 2017 Global Risks Report.

These developments also serve to shape the definitional boundaries of sustainability for a company and an industry to better enable market participants to access complete and comparable information, as well as hold companies accountable.

However, the sustainability standard-setting initiatives that accelerated the supply of sustainability information to the market through voluntary disclosure have now evolved into what many believe to be an alphabet soup of confusion. This is challenging many companies to understand and prioritize their approach to disclosure.

An organization can look to the multiple sustainability standards and frameworks to guide credible, reliable disclosure only when it has determined its material ESG impacts through extensive stakeholder consideration and engagement and then mapped those impacts to business value drivers. This assessment and mapping approach can help companies take back control of their sustainability disclosure and more efficiently respond to the varied requests for information that promote survey fatigue and dilute the relevance and value of ESG disclosure to the marketplace.

Taking these three steps—organize internally, focus on the material issues, and tell your story—will position the CFO and finance team to more effectively drive both operational and strategic change while continuing to deliver high-quality financial information and control.

**Figure 4. The four faces of finance**

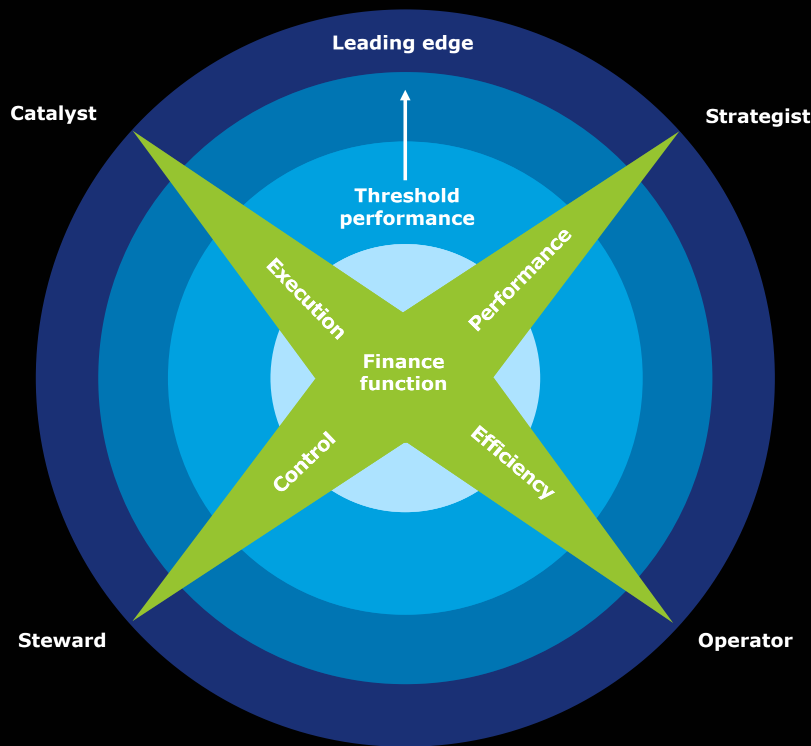
Transforming finance for sustainability can help improve the finance function's contributions to overall company value through four critical, interdependent activities: serving as a catalyst, a strategist, a steward, and an operator.

**Catalyst**

Identifying opportunities and risks for the wider, long-term perspective that sustainability brings and incentivizing behaviors and investments that support high-ROI sustainability efforts through strategic opportunity identification and risk management.

**Strategist**

Aligning investments and returns with sustainable business planning and budgeting, and developing tax planning strategies related to sustainability-focused regulations, incentives, and credits.




**Steward**

Developing metrics, key performance indicators, and external management reporting processes to report how sustainability initiatives are performing and how they translate into shareholder value.

**Operator**

Delivering capabilities, talent, and service levels to fulfill the finance organization's responsibility in supporting business-oriented sustainability.

Source: Finance transformed for sustainability – Driving Stronger Business Performance, Deloitte LLP

# A path to sustainability leadership

ESG risk is more than just another item in the long list of concerns companies must manage. It's an important business driver that has strong potential to power performance. ESG initiatives contribute to outcomes across the value creation continuum, from reducing costs to enabling differentiation in the marketplace.

The importance of sustainability risk to businesses is growing in the face of heightened expectations among shareholders, regulators, communities, and other stakeholders. If left unaddressed, these pre-financial risks could turn into clear and tangible financial impacts. Yet there's no reason that certain risks—effectively identified, measured, managed, and communicated—shouldn't help drive corporate performance and protect a company's brand and reputation. Companies that address these issues directly with the guidance and involvement of the CFO can be better prepared to create enterprise value while meeting sustainability reporting demands and broader stakeholder expectations of responsible risk management. So don't just run the numbers and report, use them in seeking sustainable value creation.

**Ask yourself:**

- Have we integrated sustainability risks into our enterprise risk management process?
- Have we incorporated sustainability priorities and initiatives into our business strategy?
- What sustainability information do we provide to our board or audit committee to enable governance over sustainability performance?
- Do sustainability measurement and reporting practices enable management to effectively communicate how sustainability drives value for the organization?
- Is there clear governance around our sustainability reporting processes and controls?

## Endnotes


1. *Recommendations of the Task Force on Climate-related Financial Disclosures*. Financial Stability Board Task Force on Climate-related Financial Disclosures (FSB TCFD). December 2016. Available at: https://www.fsb-tcfd.org/wp-content/uploads/2016/12/16_1221_TCFD_Report_Letter.pdf
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