10-2022

The alphabet soup in reporting and measuring ESG

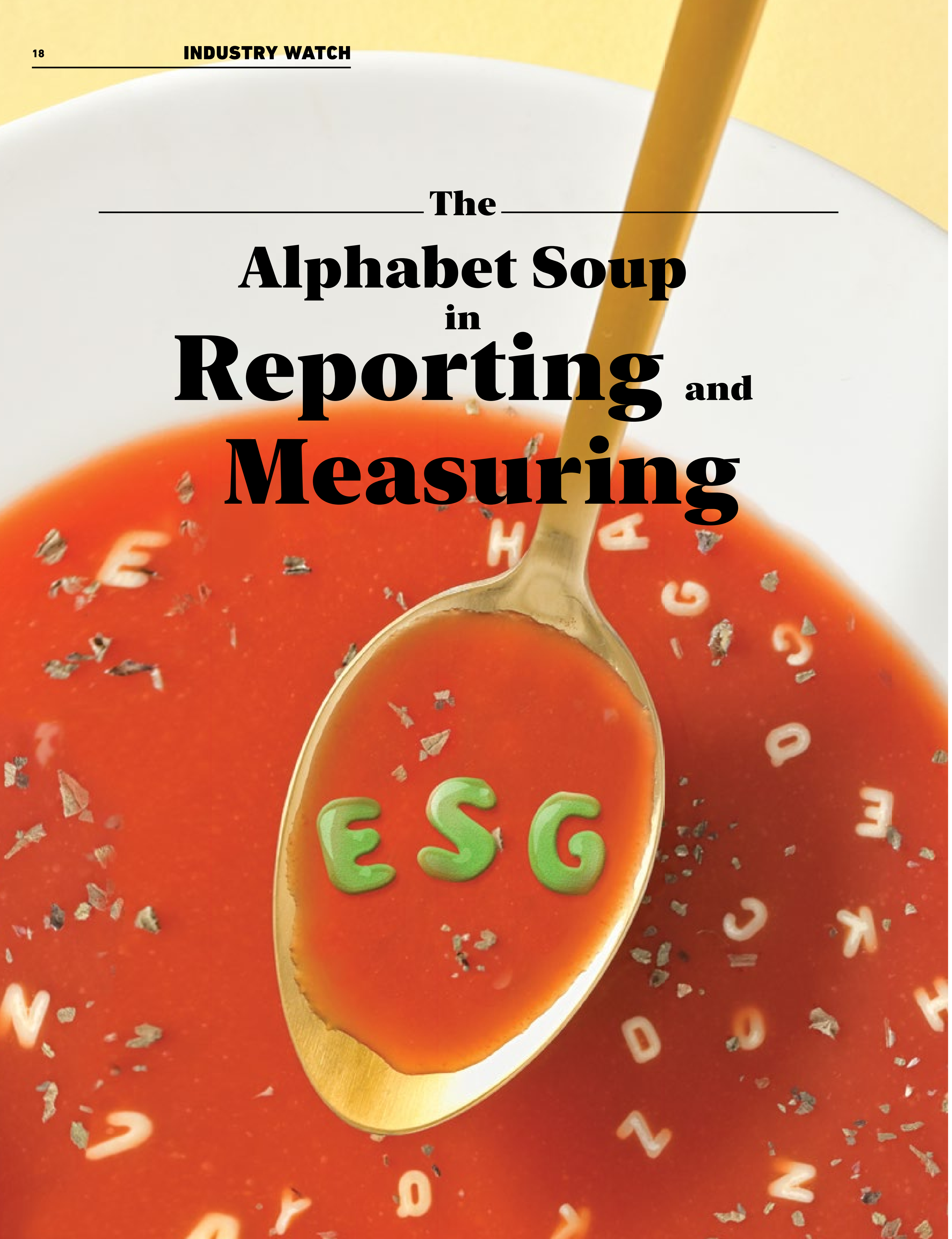
Hao LIANG
Singapore Management University, hliang@smu.edu.sg

Kam Chee CHAN
Singapore Management University, kcchan.2019@economics.smu.edu.sg

Citation

LIANG, Hao and CHAN, Kam Chee. The alphabet soup in reporting and measuring ESG. (2022). *Asian Management Insights*. 9, (2), 19-24.

Available at: https://ink.library.smu.edu.sg/lkcsb_research/7153



The Alphabet Soup in Reporting and Measuring

Harmonising frameworks with the Impact-Weighted Accounts Framework.

by Liang Hao and Chan Kam Chee

"How dare you!" These were the words Swedish climate activist Greta Thunberg had for world leaders at the 2019 United Nations (UN) Climate Action Summit in New York, admonishing them for their failure to take stronger actions to tackle climate change.

In 2015, all UN members had adopted the Sustainable Development Goals (SDGs)[1]—a set of objectives aimed at providing a blueprint for nations to address various societal issues and protect the planet. With that, environmental, social and governance (ESG) issues came to the forefront, capturing the attention of civil society and the business community. Corporations and investors could no longer ignore the ESG impact that businesses have on society and nature, given the rising social activism for such issues.

On the environmental side, global warming has made it impossible for people to avoid or mitigate adequately the effects of extreme climate conditions. Heatwaves and forest fires in Europe and the US, as well as floods in China, India, and Japan—these extreme climate events are now an annual affair for people living in many parts of the world. Climate change is something we cannot ignore today and there is tremendous pressure on both governments and businesses to curb the emission of greenhouse gases (GHG). Since the UN Climate Change Conference 2015 adopted the Conference of the Parties (COP) 21 Paris Climate Agreement, global leaders have pledged to keep global warming to 2°C below pre-industrial levels and have announced ambitious plans to cut GHG emissions to attain net-zero carbon emission within the next few decades. Other environmental issues such as pollution, deforestation, and the loss of biodiversity have also attracted the attention of climate activists, who demand stronger actions from governments and corporations to address the negative impact of these activities.

There is also rising awareness of social issues, especially gender inequality, poverty, and child labour. A report by the World Inequality Lab in 2021 revealed that the richest 10 percent of the world's population owns 76 percent of global wealth, while the poorest half owns just two percent of all wealth.[2] The COVID-19 pandemic has only exacerbated such social issues. For example, when nations were locked down and people were forced to work from home, many working women were compelled to take on additional childcare and family responsibilities at the expense of their jobs, which worsened the gender inequality of the workforce.

In terms of corporate governance, the same issues have been hampering the development of an efficient marketplace despite repeated efforts by regulators to curb such malpractices. Despite the fall of Enron in the early 2000s, accounting scandals continue to plague the market. For example, in June 2020, Luckin Coffee from China was delisted from the Nasdaq and Wirecard from Germany filed for bankruptcy. Both companies fell due to accounting frauds, highlighting the difficulty organisations face when adopting good corporate governance practices despite decades of implementing regulatory reforms.

Climate change is something we cannot ignore today and there is tremendous pressure on both governments and businesses to curb the emission of greenhouse gases.

With increasing pressure to tackle these ESG issues through corporate social responsibility (CSR) and socially responsible investment (SRI) initiatives, trillions of dollars have been invested in sustainability-related areas. However, it appears that little is known about how to measure ESG impact in a quantifiable and objective way, and whether these CSR and SRI initiatives are really leading to positive changes. Many have argued that several CSR and SRI initiatives are simply greenwashing–a practice where companies provide false or misleading information to make the company look more environmentally-friendly than it actually is. In fact, Bloomberg Intelligence has reported that the managers of almost a third of global total assets under management (estimated to be US$40 trillion) in the ESG industry have inflated their ESG claims.[3]

Such ESG measurement challenges are largely due to the lack of a standardised framework in measuring ESG impact. There has been increasing consensus about the need to standardise measurement, disclosure, and reporting frameworks to help policymakers, investors, and managers better gauge the true 'ESG-ness' of a company.

THE RISE OF ESG REPORTING FRAMEWORKS

Globally, numerous non-profit and inter-governmental organisations have provided recommendations and frameworks for ESG reporting. However, these frameworks differ significantly in terms of the breadth and depth in the disclosure required. For example, some ask for broad ESG and sustainability disclosure; others narrow their requirements to specific reporting parameters, such as GHG emissions. Moreover, some are mandatory disclosures while others remain voluntary.

Some major ESG reporting frameworks include Global Reporting Initiative (GRI), which is one of the most widely used standards for sustainability reporting, Integrated Reporting Framework (also known as ‹IR›), and Sustainability Accounting Standards Board (SASB) Standards. Other more specific ESG reporting frameworks include the Financial Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD), as well as the GHG Protocol initiated by the World Resources Institute (WRI) and the World Business Council for Sustainable Development (WBCSD), which develop recommendations on the types of information that companies should disclose to help governments and businesses respond to climate change.

Many of these reporting frameworks are non-mandatory and aim to provide users a basis to measure the ESG impact their businesses have on society. Some other frameworks might be more outward/inward-looking depending on how they were developed. While the myriad of options has made it difficult for investors and companies to select the appropriate framework to use, some of these framework providers have started to come together to harmonise their standards to promote a wider adoption of such frameworks. For example, the Value Reporting Foundation was formed in June 2021 following the merger of the International Integrated Reporting Council (IIRC) and the SASB.[4] In November 2021, the International Financial Reporting Standards (IFRS) Foundation Trustees launched the International Sustainability Standards Board or ISSB, a new standard-setting board to provide a comprehensive global baseline for sustainability reporting, as an alternative to the GRI framework. This move was meant to consolidate the Climate Disclosure Standards Board (CDSB)–an initiative of CDP, formerly known as the Climate Disclosure Project–and the Value Reporting Foundation (VRF). Figure 1 illustrates how some of the highlighted standards have converged over the years.

Increasingly, national regulators are mandating companies to publish ESG reports, in addition to the typical annual financial reports, and getting them to be more accountable for their actions on society and nature. This is in part a response to the significant concerns

> Many have argued that several CSR and SRI initiatives are simply greenwashing–a practice where companies provide false or misleading information to make the company look more environmentally-friendly than it actually is.

CONVERGENCE OF DISCLOSURE STANDARDS

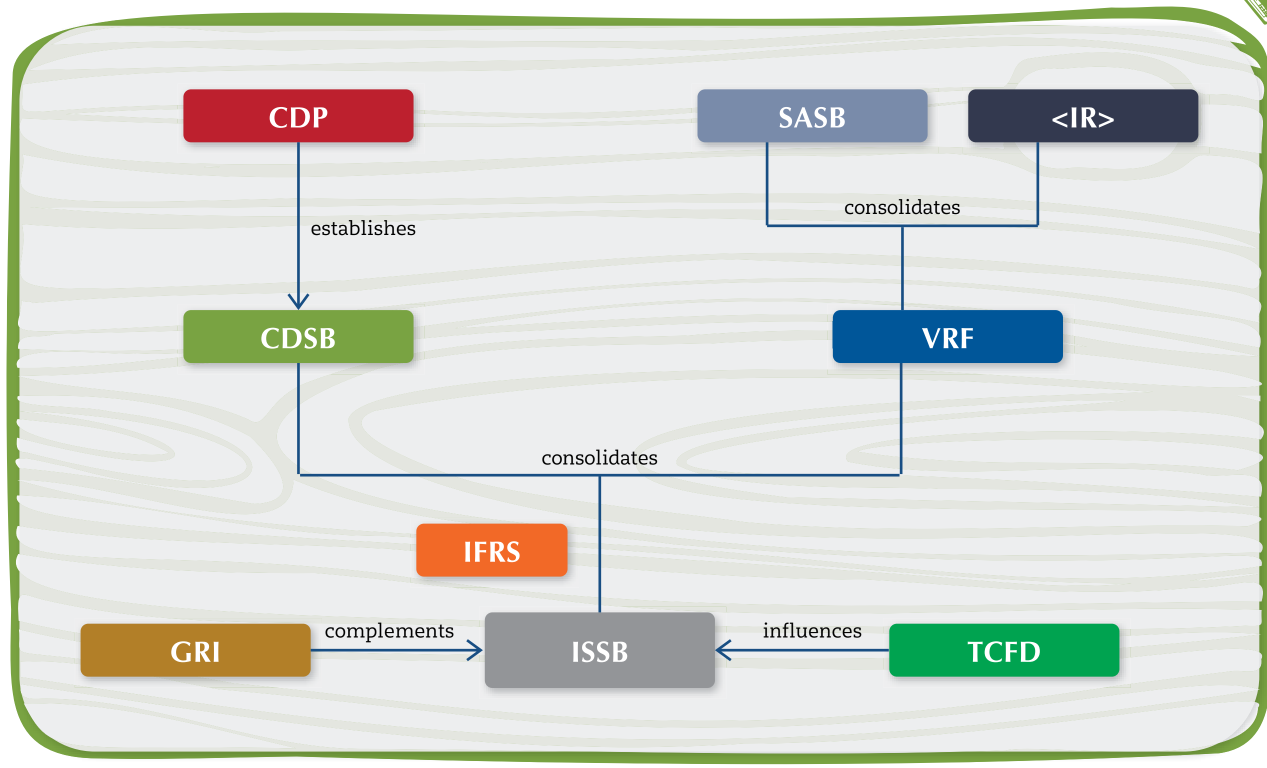


FIGURE 1

Adapted from CETAB Titan

about measuring ESG and greenwashing. As a result, besides the non-mandatory ESG frameworks introduced by the global non-profit and inter-governmental organisations, individual national regulators have also implemented different ESG reporting requirements for companies operating in their country. For example, the EU has been one of the forebearers in imposing mandated ESG reporting regimes on companies operating in the region. The EU Taxonomy is an EU classification system that aims to help companies, investors, and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable. It is also accompanied by the EU Sustainable Finance Disclosure Regulation and the Corporate Sustainability Reporting Directive to ensure that companies adopt the same definition of sustainability.

In Singapore, companies listed on the Singapore Exchange (SGX) are required to publish climate reporting and report carbon emissions using the TCFD recommendation from the financial year commencing 2023. SGX Regulation and the Accounting and Corporate Regulatory Authority also announced plans in June 2022 to jointly set up a committee to advise local companies on a sustainability reporting roadmap.[5] These regulatory actions highlight the importance that regulators are placing on the climate disclosure of companies to ensure that appropriate disclosures are made to investors.

TOO MANY COOKS SPOIL THE (ESG STANDARDS) BROTH?

Nonetheless, the lack of a standardised ESG reporting framework has led to many issues, and stakeholders like investors and scholars are increasingly scrutinising the effectiveness and accuracy of the wide range of ESG reporting standards available in the market today. Meanwhile, more and more people are looking into ESG ratings provided by third-party rating agencies to evaluate the 'ESG-ness' of companies.

According to a study by professional services firm EY, there are about 100 different ESG rating providers in the market as of October 2021,[6] which is double that for the year before. This no doubt raises questions about which agency an investor should rely on. Besides, the opaque research methodologies employed by the various rating agencies do not make the decision any easier for users. Research has shown that there was a major divergence in

ESG ratings for the same company when these ratings were obtained from different providers, due to the range of methodologies adopted by the various agencies, with the correlation of ESG ratings for the same company ranging from as low as 38 percent to as high as 71 percent.[7] In addition, there might be biases in such ESG ratings where larger companies tend to have higher ratings as they have more resources to support ESG disclosure requirements.[8] This led scholars to introduce the term 'aggregate confusion' because investors will likely get conflicting information as the same company can have very different ESG ratings from various rating agencies, making it difficult for them to make informed investment decisions.

In another study, researchers compared the differences in ESG scores from Refinitiv, a subsidiary of the London Stock Exchange Group, over two different periods and found that some ESG ratings were dramatically different for the same firm over the two periods.[9] Although potential reasons for the re-ratings may be due to the addition or removal of disclosure and time-varying traits of firms, the authors were unable to access the ESG provider's research methodology to arrive at an accurate explanation for the deviation. Given the opaque methodologies used by different ESG rating agencies, it is not surprising that critics complain that the agencies are trying to change the narrative of a company's past actions–or what the researchers call 'rewriting history'–without providing an objective explanation for such changes. It leads them to question the reliability of some ratings, given that most ESG providers do not publish their methodology due to issues like intellectual property and commercial sensitivity. This non-transparent nature of many ESG rating providers does not bode well for the development of ESG ratings, as trust is essential to promote the use of such ratings when guiding corporations and investors in their actions.

At the same time, the dramatic rise of the ESG reporting industry over the past few years will no doubt attract more interest and scrutiny from investors and financial regulators, and regulators globally have already taken action to investigate suspicious practices. In June 2022, a unit of Deutsche Bank, DWS, was raided by the German regulator over claims of exaggerating its ESG reporting capabilities.[10] Within the same month, the US Securities and Exchange Commission (SEC) announced that it was investigating some of the ESG rating products offered by Goldman Sachs, and planning to tighten its ESG disclosure requirements to ensure companies are truly committed to such claims.[11,12] In another instance, the Development Bank of Japan announced plans to scrutinise the use of its funds to ensure that companies are not greenwashing when making investment decisions.[13]

INTRODUCING THE IMPACT-WEIGHTED ACCOUNTS FRAMEWORK

To play its part in tackling the issues mentioned above, the Singapore Green Finance Centre (SGFC) at the Singapore Management University (SMU) has been working on a more holistic, transparent, and comparable ESG impact reporting framework. Together with partners from the Harvard Business School, the Rotterdam School of Management, the Impact Institute, and the Impact Economy Foundation, the SGFC has been working on developing the Impact-Weighted Accounts Framework (IWAF).

The premise is that sustainable value can be measured through impacts, which show how activities affect societal welfare and the natural environment. Impact-Weighted Accounts (IWAs) supplement traditional financial accounts and are a way for organisations to quantify their impacts. The IWAF aims to expand the traditional performance measurement from financial capital (i.e., profits) to the other five capitals in a firm's financial statements: manufactured capital (e.g., client value of products), intellectual capital (e.g., creation of intellectual property), social capital (e.g., contribution to the community), human capital (e.g., the wellbeing of employees), and natural capital (e.g., contribution to climate change). With these six capitals, organisations can compile their Integrated Profit & Loss (IP&L) accounts and Integrated Balance Sheet (IBaS). The IBaS can also be expanded to include the stakeholder value created over a longer or pre-determined period.

By expanding the impact produced by a firm beyond the financial profits it generates, the IWAF aims to provide investors and other stakeholders with an alternative framework to evaluate the impact a firm has on society and the environment. It shows the value creation or reduction for all the stakeholders of an organisation: employees, customers, the environment, and the broader society. With this in mind, the IWAF has been adopted by some companies such as Dutch bank ABN AMRO.

The IWAF thus aims to fill the gap of a missing international standard by ensuring complete and consistent IWAs. Under the framework, five common topics of non-financial impact assessment have been identified, and they are addressed using 10 principles to ensure that IWAs inform impact decisions (refer to Table 1).

IMPACT-WEIGHTED ACCOUNTS FRAMEWORK

TOPICS	PRINCIPLES
Identification Which impacts are my responsibility?	**Multi-dimensional** Impacts can reflect different forms of value and value for different stakeholders
	Materiality based An impact is material if it affects future earnings or if it affects welfare of stakeholders
	Welfare based IWAF includes at least two welfare categories: wellbeing and the respect of rights
	Value chain responsibility Organisations have a responsibility for the impact of their value chain partners
Measurement How do I measure societal impacts?	**Impact–pathway based** Impact is about outcomes–how the welfare of stakeholders is affected
	Complete reference view Impact is defined with respect to a specific reference scenario
Comparability What are the relative sizes of impacts?	**Valued in commensurable unit** Monetary valuation allows impacts to be compared
Aggregation How to make sense of many impacts?	**Only within welfare categories** Negative impacts (of the rights dimension) shall not be netted against positive impacts
	Conservation of impact Impact contribution ensures total impact is counted exactly once
Presentation How to comprehensively present impacts?	**Statements of IWAs** Integrated Profit & Loss, Integrated Balance Sheet, and derived Statements

TABLE 1 Source: Impact Economy Foundation

The IWAF was designed after considering existing reporting frameworks like GRI, SASB and ‹IR›. Furthermore, given that many ESG reporting frameworks are formulated with a Western perspective, Asian industry partners have been consulted to customise and adapt the IWAF to suit the unique needs of Asian organisations.

Even before the promulgation of the IWAF framework, Asian organisations have begun exploring how to better measure ESG impact and improve their sustainability practices. One such organisation is DBS, a multinational bank headquartered in Singapore. It conducted an impact study in partnership with SMU and the Impact Institute to evaluate the ESG impact of its lending on the automotive and palm oil industries.[14] After reviewing the results from both studies, DBS has adopted the No Deforestation, No Peat, and No Exploitation (NDPE) policies, which are expected to reduce the negative impacts by up to 49 percent when it lends to the palm oil industry. The review also gave the bank a strong motivation to increase its lending to the electric vehicle industry to better manage the environmental risks associated with combustion engine vehicles. Over the past few years, the SGFC has also completed a few pilot schemes with its industry partners to incorporate the IWAF into their ESG disclosure. From these studies, we can see tangible outcomes where the IWAF has nudged an organisation to review and adopt practices that have positive impacts on society.

Apart from the traditional industries like agriculture and manufacturing, the impact of Asia's real estate industry on society is often overlooked. With building and construction contributing nearly 40 percent of global carbon emissions,[15] this is an industry that the SGFC is hoping to partner with to apply the IWAF.

CONCLUSION

Issues like climate change and social inequality have elevated ESG reporting from a good-to-have report to an important social 'licence' if businesses want to maintain their legitimacy and continue thriving in the current business climate. Apart from the mounting public pressure, financial regulators globally are also making such ESG disclosure mandatory for companies so that investors can make informed choices, leading to the emergence of different ESG reporting and measurement frameworks that can sometimes confuse and even possibly mislead stakeholders.

Nonetheless, reaching a consensus on a standardised sustainability reporting and measurement framework is no mean feat. It requires stakeholders with differing interests and agendas to come together and agree on an acceptable framework for the industry to adopt in order to provide a true and fair representation of a firm's ESG efforts. A framework that is too onerous would disincentivise corporations from adopting it, while one that is too lax could lead to issues like greenwashing and render the framework ineffective.

Finding that sweet spot to balance the efficiency and effectiveness of such frameworks would require more hard work in the years to come. If successful, it would be a robust response to Thunberg's call for businesses and organisations to act faster and stronger together to fight climate change. AMI

Dr Liang Hao

is Associate Professor of Finance and Co-Director of Singapore Green Finance Centre at Singapore Management University

Chan Kam Chee

is a student at Singapore Management University

Endnotes

1 The UN SDGs are a collection of 17 global goals to be achieved by 2030, which were adopted by the UN General Assembly in 2015. Each SDG has a separate list of targets to achieve–there are 169 in total–covering social and economic development issues such as poverty, hunger, health, education, global warming, gender equality, water, energy, urbanisation, environment, and social justice.

2 Joe Myers, "These Charts Show the Growing Income Inequality between the World's Richest and Poorest", World Economic Forum, December 10, 2021.

3 The Business Times, "Goldman Investigation Tarnishes ESG Halo as Investors Bail", June 15, 2022.

4 Value Reporting Foundation, "IIRC and SASB Form the Value Reporting Foundation, Providing Comprehensive Suite of Tools to Assess, Manage and Communicate Value", June 9, 2021.

5 Uma Devi, "Acra, SGX RegCo Set up Sustainability Reporting Advisory Committee", The Business Times, June 21, 2022.

6 Alan Livsey, "Boom in ESG Ratings Leaves Trail of Confusion", Financial Times, March 19, 2022.

7 Robin Wigglesworth, "Aggregate ESG Confusion", Financial Times, May 31, 2022.

8 The Economist, "Climate Change Has Made ESG a Force in Investing", December 7, 2019.

9 Florian Berg, Kornelia Fabisik, and Zacharias Sautner, "Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings", European Corporate Governance Institute–Finance Working Paper 708/2020, August 24, 2021.

10 The Business Times, "Deutsche Bank's DWS to Keep ESG Focus after Greenwashing Claims", June 7, 2022.

11 Patrick Temple-West and Joshua Franklin, "SEC Investigating Goldman Sachs for ESG Claims", Financial Times, June 11, 2022.

12 The Business Times, "US Securities Regulators Unveil Proposal to Fight 'Greenwashing'", May 26, 2022.

13 The Business Times, "Deutsche Bank's DWS to Keep ESG Focus after Greenwashing Claims", June 7, 2022.

14 DBS, "Measuring Impact: Understanding and Managing Impacts from Our Business".

15 Amanda Phua, "Cushman & Wakefield's Report Examines Market Drivers and Pathways to Meaningful Climate Action for the Property Industry", Cushman & Wakefield, October 27, 2021.