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ESG and FEQs – Frequent Environmental Questions

By Todd Roessler

As the effects of the COVID-19 pandemic, climate change, globalization, technology, and society and consumer behavior continue to grow and evolve, it's important that companies take actions to address these short-term and long-term changes. The rise in ESG issues over the past few years is not only likely to continue in 2023 and beyond, it will likely grow. Incorporating ESG into a company's strategy is essential to address and mitigate these risks and is also an emerging factor to identify opportunities resulting in financial growth. Before a company can meaningfully address ESG issues, however, it must understand ESG standards and principles.

This series is intended as a guide to help you navigate these complex issues to start or enhance your ESG journey.

What is "ESG"?

Starting with a seemingly simple question may appear straightforward, but, like ESG, becomes more complex the deeper the issue is explored. Most know that "ESG" stands for Environmental, Social, and Governance. Beyond this, there is little agreement. ESG covers an extremely broad range of issues from reducing carbon emissions to ethical sourcing and data protection and privacy. Labels attached to ESG, such as "sustainable," "responsible," and "ethical," do not have consistent meanings and concepts have evolved over time. Each sector of the economy faces unique ESG issues. Companies in the energy or manufacturing industry sectors may be heavily weighted for the Environmental pillar, while the Governance pillar may be more important to other industries, such as large banks and financial institutions. Thus, ESG has a different meaning for each company.

Companies must decide what ESG issues are "material" to them. The Securities and Exchange Commission (SEC) finds a matter to be "material" when "there is a substantial likelihood that a reasonable investor would consider it important." Materiality, however, is dynamic, and companies must respond to rapidly changing conditions. Immaterial factors can quickly become material. In response to the COVID-19 pandemic, companies needed to make sweeping changes to protect their employees. As a result of range of factors, including geopolitical instability, climate change, natural disasters, cyber attacks, and the pandemic, many companies now face supply chain disruptions. Further, traditionally, materiality has applied to issues, including ESG, that can impact a company's financial performance, such as reputation loss or lost revenue as a results of a consumer choosing a more "sustainable" product. More companies, however, are now recognizing that materiality can also encompass socially material issues, such as seeking to accomplish positive change in response to consumer activism. As a result of the public's growing environmental and social awareness, a "new" regulator (the public) is demanding more from companies, which requires that companies fully assess ESG criteria to evaluate corporate risk and performance.

Rather than trying to define what ESG encompasses, it might be more helpful to consider what ESG is intended to address. ESG is used by investors to evaluate corporate behavior and to determine the future financial performance of companies. In other words, it's a lens to evaluate a company's response to a range of environmental and social issues and the systems a company has in place to evaluate and monitor a company's performance to understand these risks and identify opportunities. Put simply, ESG is the collection of environmental, social, and governance factors that can materially affect a business. It's evaluating these risks and opportunities that have been traditionally thought outside of the business.

Environmental: Environmental factors typically relate to evaluating the direct and indirect impact of a company on the natural environment, including GHG emissions, energy usage, water usage, waste management, environmental operations, climate oversight, and climate risk mitigation.

Social: The social category encompasses issues like social justice and equity, diversity and gender initiatives, labor practices, executive compensation, and human rights.

Governance: The governance category describes the internal systems that a company uses to meet the needs of its stakeholders, including transparency, metrics, data security, risk management, supplier code of conduct, disclosure practices, external assurance, and board oversight.

As discussed above, not all ESG topics are relevant or material to every company, and there is no "one size fits all" answer. A risk-based, cost-effective, and tailored approach is recommended to address ESG issues according to a company's needs, no matter where it is in its ESG journey.

From this starting point, we will further explore the complexities of ESG and try to understand the driving forces of the ESG trend, the different approaches that companies are taking, and the risks and opportunities that these approaches present.

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