



Going from good to great:
Ways to make your
sustainability report
business-critical

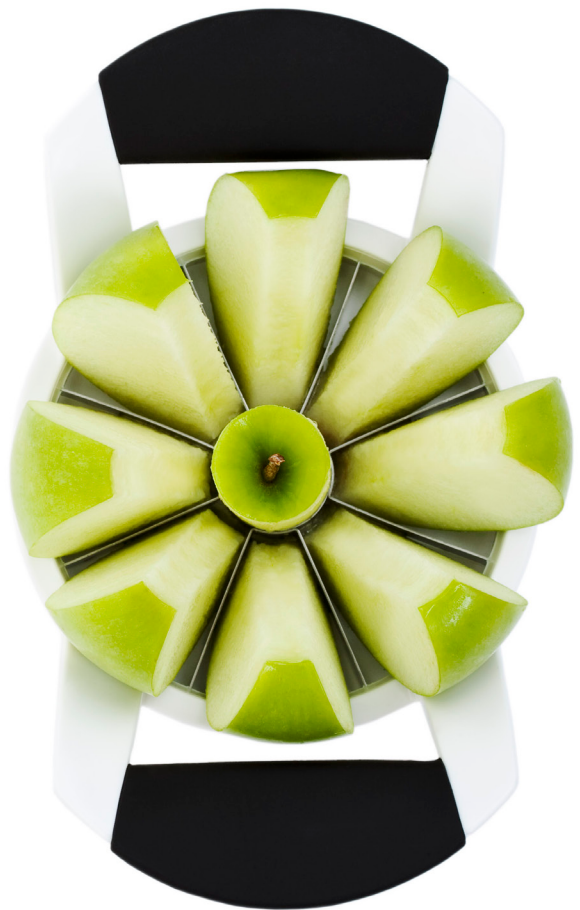


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Overview

In 2011 nearly 6,000 organizations around the globe invested significant time and effort in monitoring and disclosing their sustainability performance¹, or ESG — environmental, social and governance — performance, usually in a sustainability report that is separate from a financial statement. The steady increase in volume of sustainability reporting over recent years, including many well-known global companies, seems to indicate that many executive and governance leaders believe issuing a sustainability report is important. However, based on our discussions with hundreds of stakeholders on this subject, we also find a strong counter-current from various categories of stakeholders that question the value of the ESG information as a basis for business and investment decisions.

Given the growing chorus of concerns, we believe sustainability reporting is at a crossroads. The choices are: Continue to collect, analyze, and communicate data that decision makers, investors, and customers may ignore; or create a reporting process that is more fully integrated into meaningful and substantive business and investment decisions — decisions that can impact value and competitive advantage. The key is to make ESG information more decision-relevant, including those decisions related to tracking, monitoring, performance evaluation and incentives.

As we will discuss here, there are tremendous benefits that may be gained from improved ESG reporting:

- Attract investment into your company because the focus is on business-relevant information
- Direct how your company allocates capital and formulates its core business strategy
- Build and strengthen your company's reputation and value proposition
- Address stakeholder concerns credibly

In order to go from good to great — to make sustainability reporting business-critical — companies should consider adopting a more robust methodology for determining ESG materiality. In fact, we believe that the most effective way to successfully evaluate the materiality of ESG issues — and to truly derive a business value from sustainability reporting — is to integrate them into the company's overall business model which drives its valuation.



¹ See: <http://www.corporateregister.com/a10723/36941-11th-8607253C8215604518E-GI.pdf>

Understanding the need for *materiality* in today's environment

The questions raised by stakeholders — investors in particular — are not trivial. They may reveal a perceived credibility deficit both internally and externally:

- Internally, few managers are linking ESG issues to corporate strategy and value creation, creating a perception that the information is not useful.
- Externally, investors and other stakeholders question whether the information is business-critical and the lack of benchmark ESG metrics even within an industry raises the question as to whether ESG information can help them make better decisions.

Transparency is a good thing — it can help reduce transaction costs, can reduce a company's cost of capital² and may attract new capital to companies that demonstrate their ability to create future value. Today, investors pay more attention to a company's intangible assets, because they are thought to account for 80% of a company's market value compared with tangible assets, see figure 1. Non-financial metrics used to measure intangible assets and liabilities help investors create a better picture of a company's long-term organizational strategies to build intellectual capital, customer loyalty, sustainability risk management, and resilience in the face of rapidly shifting marketplace demands, among others.³ Yet most businesses are not very good at measuring these non-financial intangibles compared with traditional

financial metrics that capture a company's tangible short term performance. Turns out the rewards for paying more attention to non-financial data, including ESG data, can be significant — it helps companies leverage up to 80 percent of their market value.

Most companies today select which ESG data to disclose based on their own intuition and experience, one-on-one consultations with stakeholders or stakeholder panels (e.g., customers, employees, suppliers, and communities). However, these methods do not help managers establish a *relative* ranking of ESG issues based upon what matters the most to the business, in part because these approaches do not often include senior leadership and are not quantitative enough. At its root the challenge is two-fold:

- How to link management of ESG issues to creation or protection of business value
- Balancing financial and non-financial data, especially when managers are accustomed to dealing with financial data on a daily basis, but have little experience with ESG issues, which tend to be measured in non-financial units or qualitative data

Can the conversation on sustainability reporting bring together sustainability managers with the CFO, controller, and other stakeholders central to measuring, evaluating, and *investing* in the business's long-term growth strategy? Yes, if the information is:

- Aligned with the business's strategic objectives
- Understood as part of the value proposition for various investment projects
- Incorporated into the assessment of how various projects are evaluated
- Effectively communicated with a direct linkage to the business's strategic objectives

We believe that by applying the principle of materiality the focus will be on fewer ESG disclosures and will make the link to valuation more explicit. The principle is well established in traditional financial reporting and emphasizes how information can change the way its users

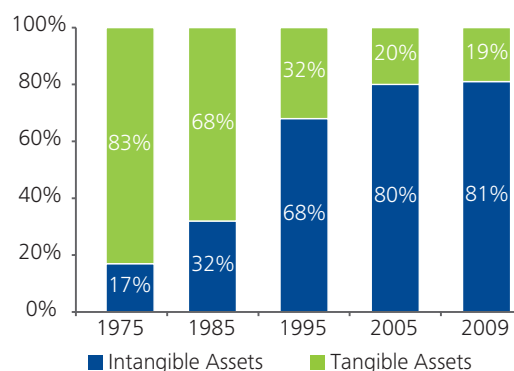


Figure 1: Components of S&P 500 market value

Source: Ocean Tomo, "Ocean Tomo's Intangible Asset Market Value Study," 2010

² Douglas W. Diamond and Robert E. Verrecchia, "Disclosure, liquidity and the cost of equity capital," *Journal of Finance* 46(1991).

³ Christopher Ittner and David Larcker, "Non-financial Performance Measures: What works and what doesn't", *Financial Times'* Mastering Management series, Oct. 16, 2000

assess a business's performance and growth prospects. According to SEC Staff Accounting Bulletin 99, a matter is "material" if "there is a substantial likelihood that a reasonable person would consider it important." Financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.⁴

Materiality can help with ESG metric selection because it:

- Imposes a disciplined approach to focusing on data that is useful for business and investment decisions
- Helps companies focus the amount of ESG information disclosed to those that are business-critical
- Can improve the flow of capital to those companies that limit the negative social and environmental impacts of their business activities and improve their prospects for future value generation

Currently, a variety of global and U.S.-specific initiatives are underway to bring more clarity to which key performance indicators (KPIs) should be disclosed within the next three to five years (See accompanying sidebar: "Major Reporting Efforts Underway"). In the meantime, we suggest an approach that builds on multi-stakeholder engagement processes used by many companies today — one that places the organization's business objectives at the core of the reporting process right at the start of an ESG materiality assessment.

Major Reporting Efforts Underway

Global Reporting Initiative (GRI) was launched in 1999 and has produced several iterations of a voluntary sustainability reporting framework for disclosure on key areas of economic, environmental, social and governance performance. The network is currently working on the G4 Guidelines, which are to be launched in 2013. G4 puts much greater emphasis on materiality determination as part of the disclosure process.

Carbon Disclosure Project (CDP) was launched in May 2002 by 35 institutional investors representing assets in excess of US\$4.5 trillion who wrote to the Chairmen of the FT500 Global Index companies asking for investment relevant information relating to greenhouse gas mitigation. The first annual report came out in 2003 and today industry, country and city level reports are being issued, in addition to CDP Water Disclosure launched in 2009. CDP has become the de facto standard for voluntary disclosure of greenhouse gas emissions, risks, including supply chain risks.

International Integrated Reporting Council (IIRC), founded in 2010, is developing a framework for integrated reporting that demonstrates the linkages between an organization's strategy, governance and financial performance and the social, environmental and economic context within which it operates in a clear, concise, consistent, and comparable format. IIRC issued a discussion paper in September 2011 describing the rationale for Integrated Reporting, and offered an initial proposal for the development of an International Integrated Reporting Framework. An outline of the framework was released in July 2012. They expect to release a first version of the framework in late 2013. The Council continues to develop the framework, including guidance on how to determine materiality, and is working with 70 pilot companies on the implementation of the framework.

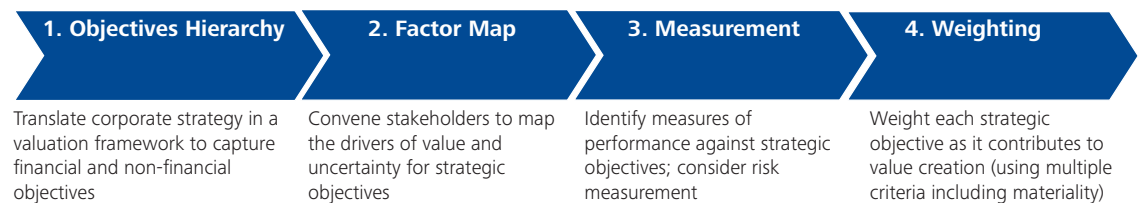
Modeled on the Financial Accounting Standards Board (FASB) **Sustainability Accounting Standards Board (SASB)**, launched in 2011, collaborates with regulatory and accounting organizations (e.g. SEC, Center for Audit Quality, PCAOB) to aid in the development and dissemination of a set of industry-specific sustainability reporting standards for disclosure in standard filings such as the Form 10-K. SASB plans to identify which sustainability issues are material for industries to establish a minimum disclosure standard that is concise, comparable within an industry, and relevant to all 35,000 publicly listed companies in the U.S. SASB plans to issue a complete set of standards covering all 10 sectors and 102 industries by 2015.

Global Initiative for Sustainability Ratings (GISR) was launched in June 2011 to design and implement a global sustainability ratings standard and to move existing sustainability ratings toward a core set of principles, process, and performance. Fostering convergence and harmonization across ratings will enhance the quality and comparability of material information needed to move markets toward more sustainable outcomes. The group seeks to develop this framework within the next two years.

⁴ See: <http://www.sec.gov/interp/account/sab99.htm#foot3>; See also: FASB, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information ("Concepts Statement No. 2"), 132 (1980).

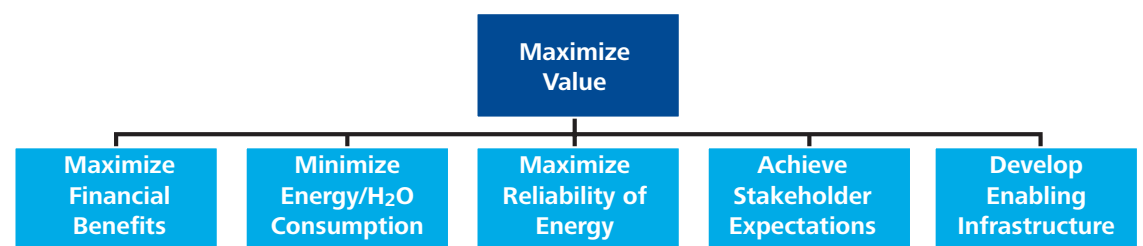
Making the link between ESG issues and corporate strategy: What does it take to be great?

Getting to great in ESG reporting depends primarily on how the organization engages with its stakeholders (internal and external) to determine which ESG issues may be most material and then focusing their efforts on the identified issues. Managers and investors need a practical way to evaluate a company's ability to create direct tangible and strategic intangible value in a consistent, defensible and less biased manner. Luckily, well-established decision support tools widely used to navigate difficult decisions can be leveraged here to analyze ESG materiality tied to an organization's objectives, as shown in the chart and sample steps that follow:



Step 1 — Translate corporate strategy into a valuation framework to capture financial and non-financial objectives

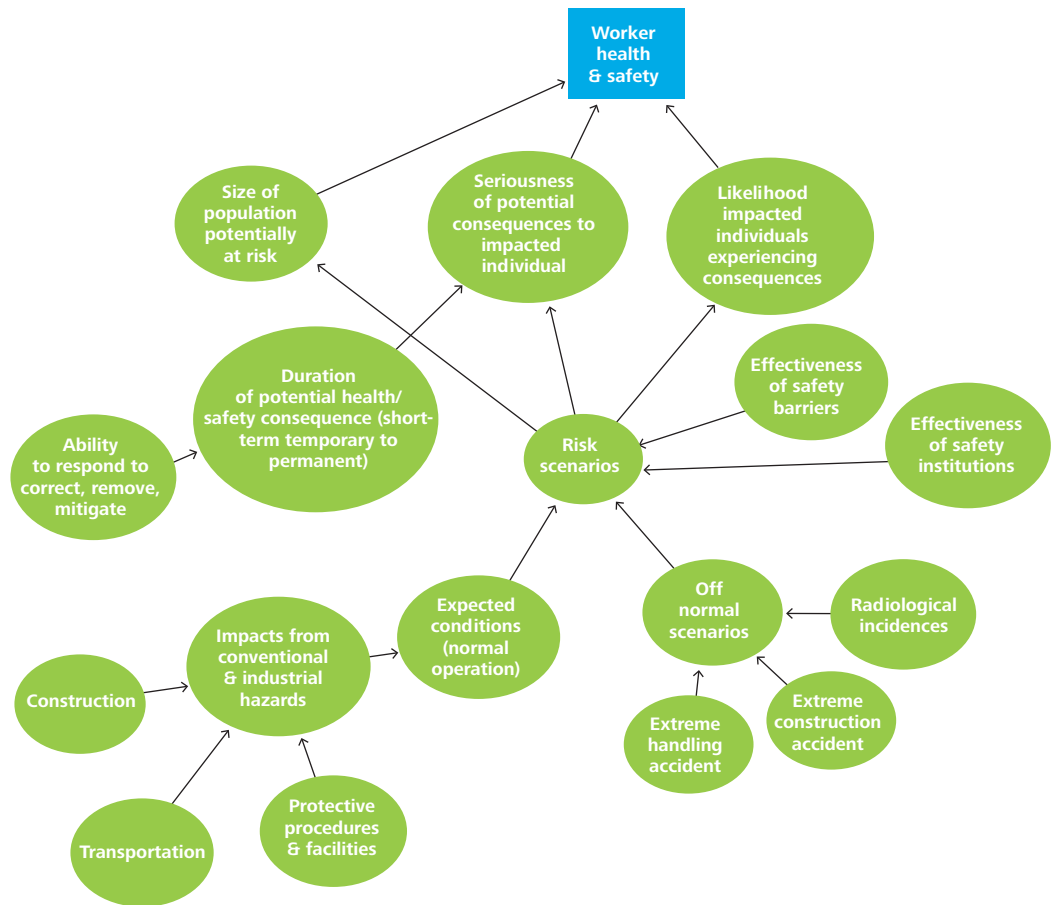
A key first step in structuring any business decision is to understand the organization's *most strategic objectives* and answer the "what do we want" question — which is unique to each organization. Strategic objectives need not be limited to financial outcomes. They can include non-financial outcomes, such as market share targets, supplier relationships, energy efficiency, meeting stakeholder expectations, brand equity, worker health and safety, etc. The goal is to identify the organization's objectives comprehensively, while making sure they do not overlap. The objectives, once articulated, can be structured in an objectives hierarchy, which makes relationships among them explicit, as shown in the example below.



The objectives hierarchy can have several levels beyond what is shown here, which is an illustrative example adapted from a government agency. For instance, the "Minimize Energy and H₂O Consumption" objective can depend on intensity of electricity usage, water intensity of production, and CO₂ equivalents saved, which, in turn, is a function of the composition of power production in the local utility. Once the hierarchy is completed, stakeholders need to identify which objectives are key, i.e., strategic, in order to maximize value. In other words, focus on those areas where information is most likely to be material to the company.

Step 2 — Convene stakeholders to map the drivers of value and uncertainty for strategic objectives

Success on each strategic objective depends on multiple drivers (or factors), as we show with an example for worker health and safety. Many ESG factors are interdependent, and understanding how they drive value is fraught with uncertainty. However, many managers know intuitively that the impact on value can be significant and know, based on experience, that incidents and accidents can be costly, cause business disruption, and deplete employee morale. Without a strong safety culture and management processes, companies can put their future financial value at risk.



Step 3 — Identify measures of performance against strategic objectives and consider risk measurement

Identifying performance measures is as important as mapping out the drivers of a company's value and future success. This means identifying performance measures for each strategic objective (whether financial or non-financial). A company's value is based on direct or *tangible* value, such as assets in place and direct financial costs and benefits from operations. Even though managers have more experience measuring direct value, they often struggle with forecasting how key risks and uncertainties might impact future performance, or how they can ensure defensible, consistent, financial assumptions across various scenarios, including how ESG factors impact these scenarios.

In addition, value can also be created indirectly, but still be key to future growth. This includes strategic decisions on the company's managerial flexibility, system reliability,

brand value, innovation, impact on the environment, improved health and safety, customer satisfaction, etc. Creating this more strategic value is particularly appealing to investors who seek out companies with strong future growth potential and high *intangible* asset value. Strategic value is hard to measure, but there are ways to measure performance as it relates to value. Some objectives can be described through quantitative models and observable metrics, such as number of new customers, customer contacts, web visits, etc. Others, where data is missing, may be measured using proxy data. Yet others may need to be modeled, such as by developing a high-to-low, five- or seven-point scoring scale that is constructed with input from the multi-stakeholder team.

Step 4 — Weight each strategic objective

The next step — weighting — is crucial to integration of ESG issues into the company's business model and core business decisions and approach to disclosure. Building

on the first three steps, which help frame the business's strategic objectives, managers are now better positioned to create a complete picture of the company's ability to achieve its performance objectives and invest in future growth. This is where many management teams tend to fail, because they do not use a structured approach to understanding how multiple objectives jointly link into value creation and which have the greatest potential to generate value, i.e. those to weight the most.

This can be particularly vexing for sustainability managers, who watch their sustainability objectives fall by the wayside; they often have not been properly considered in the context of the company's business model. A structured multi-stakeholder workshop employing decision support tools can assign weights to each objective to "quantify" strategic benefits, using multiple criteria that includes *materiality* and enables comparing and ranking of ESG issues the company faces.

Materiality pertains to those ESG issues that can impact company valuation.⁵ For example, ESG issues can become material due to internal/external stakeholder actions driven, in part, by how they perceive whether a company is destroying or creating value. Some ESG issues will likely affect a company's bottom line in a given time frame (1–5 years) due to factors such as business interruption, consumer boycotts, regulation or license to operate. These may lie on or above a *materiality frontier*. Beyond the likelihood of direct financial impacts, there can also be impacts on strategic intangible value (e.g., brand and reputation) that may not pose an immediate threat to a company's cash flows but may affect enterprise value due to anticipated future cash flow impacts. Therefore, for those companies with a strategic objective of building a

strong reputation and/or brand, certain ESG issues should be carefully evaluated in a materiality determination, even if these impacts fall below the materiality frontier, see figure 2.

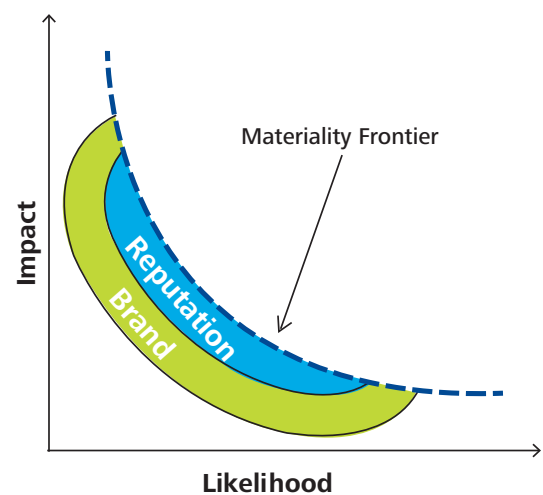


Figure 2: Materiality: function of likelihood and impact (Illustrative)

After this crucial mapping exercise, managers are in a much better position to construct a comprehensive view of the company's ability to create both direct and strategic future value, including those ESG issues deemed material to business value. Specifically, managers can now run decisions through this framework to help them identify those actions and investments that are expected to generate the most value to the company and its stakeholders, because all aspects — including ESG issues — have been considered.

⁵ See Koehler & Hespenheide, Disclosure of Long-Term Business Value: what matters, https://www.deloitte.com/view/en_US/us/Services/additional-services/sustainability-climate-change/962cef0ae3c26310VgnVCM2000001b56f00aRCRD.htm; Koehler & Hespenheide, Drivers of Long-Term Business Value: Stakeholders, stats and strategy, http://www.deloitte.com/view/en_US/us/Services/additional-services/sustainability-climate-change/a4521cabe6cc7310VgnVCM3000001c56f00aRCRD.htm

Assessing an organization's state of readiness

Getting to a more strategic view of ESG performance depends on the maturity of an organization's sustainability program and its goals, measurement system, and whether the organization wants to understand the impact of ESG performance on its valuation. Evidence is growing that stakeholders drive ESG performance and can impact financial valuation in the near term.⁶ Furthermore, a company's ESG strategy can create long-term business value — value not only to senior executives but also to shareholders who seek to identify companies that are committed to creating long-term value.

While sustainability reporting is expanding around the world, many companies do not issue a report or are just starting to consider doing so. Beginners and intermediate companies may only meet the basic expectations for disclosure and are often criticized for their lack of transparency. Many do collect data related to compliance with regulations (e.g., environment, health and safety laws), but fail to proactively engage with their (non-regulatory) stakeholders. Such an ad hoc, reactive

stance, often forces these companies to adopt a crisis management approach to various external pressures from activist stakeholders, including protests at their suppliers' facilities, boycotts, and shareholder resolutions. In each instance, the company risks negative impacts on its stock price. When external stakeholders demand ESG information, it must be collected on an issue-by-issue basis or sourced from readily available data and is not necessarily business-critical.

Companies with more mature ESG reporting capabilities have a better understanding of how their actions can impact their stakeholders and engage more proactively with them to find solutions. Through continuous engagement with a handful of stakeholders, these companies start to manage ESG risks and integrate ESG information into business decisions. These organizations use the GRI guidelines to inform what information they disclose in their sustainability report and will solicit third party review of their report, e.g., limited assurance.



⁶ See Koehler & Hespenheide, Drivers of Long-Term Business Value: Stakeholders, stats and strategy, http://www.deloitte.com/view/en_US/us/Services/additional-services/sustainability-climate-change/a4521cabe6cc7310VgnVCM3000001c56f00aRCRD.htm



Figure 3: Stages of maturity and distribution of companies in each stage

Figure 3 above illustrates the actions that an organization can pursue as it develops a more mature and forward-looking approach to the sustainability reporting process that is more integrated into how the organization creates value. No longer an ad-hoc, externally focused exercise, identification of ESG KPIs is more concerned with what is likely to be material to the company in the near- and long-term. Sustainability managers may work to bring together stakeholder panels and some use surveys to capture the concerns of many more stakeholders. These leading companies undertake a materiality determination and include a materiality matrix in their reports. These companies are making the transition from ESG risk management to value creation through effective ESG data management and are taking practical steps within their companies to integrate ESG information into business

decisions.

Finally, companies who strive for greatness in sustainability reporting are focused on how ESG measurement and management can contribute to future growth. They see sustainability as a source of innovation and competitive advantage and want to integrate it into their core business strategy. For these managers, alignment of financial and non-financial information with the company's key objectives is critical to optimizing performance and future growth. The time spent in analyzing those alignments can bring future dividends also on ESG dimensions, because those that are deemed material are stronger candidates for investment. Once ESG issues are integrated into resource allocation decisions, stakeholders, and especially shareholders, can be more confident that sustainability considerations have become part of the company's core business strategy.

Conclusion

Effective sustainability reporting should describe what the company is doing for its shareholders and its other key stakeholders by linking actions and results to the organization's objectives. A solid sustainability report, therefore, will be based on a body of meaningful credible data — quantified and tracked — and a determination of the materiality of ESG issues to the company's strategy. This bottom-up approach helps managers demonstrate that they have a solid process that has considered the entire organization's operations, key business partnerships, and stakeholder expectations. As with financial reporting, where a company is obligated to capture 100 percent of its financial transactions, ESG reporting needs to identify all potential risks that could result in a current or future financial impact.

In summary, there are several important benefits of the more robust ESG materiality determination process described in this paper, including those that help achieve:

- Improvements to the quality, defensibility, and confidence of decisions regarding ESG disclosure
- Measurable strategic value and more efficient use of resources
- Integration with other systems and data sources
- Improvements in stakeholder engagement and organizational alignment and
- Education of the organization with regard to effective ESG management

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