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advisors

BUILDING YOUR ESG PROGRAM
A STEP-BY-STEP GUIDE

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PART I

Assembling a strong team with the appropriate knowledge, bandwidth, and authority is the critical first step to building out a successful ESG program, but it often poses some initial challenges.

OVERCOMING THE CHALLENGES

The chief obstacles in launching an ESG program typically are:

Limited Bandwidth and Availability – New ESG teams consisting of current employees will likely be brought in from other teams. These individuals will have existing duties and responsibilities to prioritize, and they may also experience an extended learning curve if they are transitioning into the ESG field for the first time.

External ESG hires will also experience an initial learning curve and require training within your company to properly assess and implement your ESG strategy based on your unique positioning and needs.

This acclimation is the first challenge most companies have. Planning ahead to prioritize an efficient onboarding process will ensure employees can manage their time and current responsibilities, and new hires can get the information they need to start their work.

Limited ESG Knowledge – Many people placed on your ESG team will have little background in ESG-related matters. Although this is common, it can be intimidating to craft sound strategy and workflows without previous ESG experience. Even those with an ESG background find it challenging to keep pace with rapidly evolving regulations and demands of stakeholders.

Limited ESG Foundation – When starting an ESG program, you will be building an initiative from scratch. This is unlike financial reporting, which has decades of established laws and standards. Your company will not have guiding disclosures and internal controls that ensure you are collecting relevant and reliable data.

Limited Authority – Without authority and buy-in from company leadership, ESG teams face an uphill battle. A successful team must define authority in terms of oversight to lead and build strategy, with cooperation from appropriate internal teams.

Building the Team

ZMH Advisors have identified the types of traits that work best when launching an ESG program:

- **Project Management** – The ESG team leader should have a sound project management skillset. The job of assessing a company's current positioning requires the ESG team to collaborate cross-departmentally to collect diverse information.

- **Organization** – Creating processes which can be replicated and improved upon requires systematic documentation of contacts, processes, outcomes, and learnings. This also creates the initial groundwork for future auditing. Ensuring these documents are properly saved and organized in a consistent and logical way is essential to maintaining proper systems.

- **Communication** – Persuasive, consistent, and personalized communication is necessary to maintain positivity within your team, obtain the deliverables you seek from others within the company, and ensure the ESG team is collaborating with each other to lay proper foundations.

- **Team Player** – The ESG team often is pulled from different silos, and a lack of a formal "team" designation can result in different priorities and reporting structures. "Team player" attitudes will create more cohesion and foster robust communication to ensure fewer rifts.

- **Resourcefulness** – Commonly, proper resources are not allocated to building a strong ESG program due to a lack of buy-in from senior leadership or understanding of the scope of this project. Internal ESG teams will need to advocate for prioritizing ESG initiatives within the company.

PART II

DEVELOPING AN ESG STRATEGY

After your ESG team is assembled, you will need to craft a sustainability strategy which aligns with the company's overall mission and business plan.

In developing a sustainability strategy, you will need to consider these major drivers:

1. Who are our key stakeholders when it comes to ESG?
2. What ESG topics are relevant to those stakeholders? What KPIs are commonly reported for those topics? What should our priority metrics and targets be?
3. How should we identify and prioritize our various ESG goals so that they are best integrated with our company's existing business strategy?

WHO ARE OUR KEY STAKEHOLDERS?

Keep this broad; your initial stakeholders can include investors, regulators, customers, suppliers, employees and the communities in which you operate. Nearly all institutional investors have prioritized ESG topics- everything from climate change to social impact issues. Each year, the voting policies of these investors are increasingly more proactive; they are looking for real change, not a "check the box" attitude.

Employees are paying greater attention to their company's stance towards ESG. Employees want to take pride in what their company is doing for DEI, climate change mitigation, ethical operations, and supporting their communities. Consequences to failing the ESG test are showing up as high attrition rates and low morale.

Increasingly, customers are asking suppliers to ensure robust ESG compliance, as part of their global sustainability commitments. If you have a compelling ESG strategy, it is important to communicate that to your customers to potentially expand your base and increase retention.

Your suppliers are part of your overall ESG profile. Their sustainability policies and activities impact yours – and vice versa. Many suppliers are asking for ESG-related disclosures as they get ready for possible Scope 3 emissions reporting.

Regulators, like the SEC, are actively implementing new regulations that will establish broad disclosure requirements and compliance obligations for both climate and social topics. This is happening on a global scale and can be challenging to keep abreast of rapidly evolving regulatory developments.

How Should We Identify and Prioritize Our Various ESG Goals So That They Are Best Integrated With Our Company's Existing Strategy?

Before you can set your ESG strategy, you need to identify the foundational pieces of your company. This data is often sourced from departments that are not accustomed to disclosing this kind of information because it is not part of the regular financial reporting process. There can be pushback from those asked to participate in collecting data due to limited availability or a lack of understanding.

Without this foundation, it's difficult to figure out next steps. Senior leadership needs to set expectations, company-wide, that ESG is necessary to the company's overall business strategy moving forward.
Once you have these foundational strategy and positioning pieces, your leadership and board will help you deliberate on how to move forward; this is an ongoing process which should be revisited regularly. Agility during this process is crucial for success.

What ESG Topics Matter Most to Our Stakeholders? And What Should Be Our Metrics and Targets to Achieve Better Alignment?

Your ESG strategy should be realistic, specific, and genuine. ESG strategies should not serve marketing priorities, nor should they be positioned as "checking the stakeholder's box." There are significant legislative, financial, and reputational consequences to an inauthentic ESG strategy, also considered "greenwashing."

For institutional investors, develop an engagement program where you are periodically discussing material ESG topics with them. You will need to be educated about their ESG priorities, relevant voting policies, and shareholder proposals they are most likely to support. Investor information changes rapidly, and you may need to leverage additional resources to help you consolidate and simplify this data. ZMH's "ESG Dashboard" can help you understand the nuances of investors' ESG priorities and voting policies in this ongoing process.

Market research into industry standard metrics, targets, and KPIs will help you identify how you compare to your peers, where you may be an outlier, and where your focus points are. When deciding which metrics and targets to use, you'll need to consider what type of information you'll be required to publicly disclose. The concept of "materiality" plays into that, and ZMH Advisors has a materiality assessment service that can assist you with this crucial piece to the ESG puzzle for your company.

PART III

SETTING TARGETS & METRICS

After your team creates a strong ESG strategy, you'll need to establish a framework to execute it. An important part of this step is knowing what to consider in your target-setting process. This will enable you to choose the right metrics to track your progress.

If you're a public company, it's helpful to know what the SEC has proposed as future disclosure requirements for Greenhouse Gas (GHG) emissions, however you should not be limited to the SEC's mandated disclosures (when finalized) as there are demands from other key stakeholders beyond regulators.

Under the SEC's proposal, companies would be required to disclose the baseline year for their GHG emission targets, which would need to be consistent for all targets designated by each company. Many companies set near-term, medium-term, and even long-term targets. For those with overlapping commitment targets, such as a goal of net zero emissions by 2050 pursuant to the Paris Agreement, or a plan to cut Scope 1 and 2 emissions by 50% by 2030 and reduce Scope 3 emissions by 35% by 2030, they would be required to disclose all necessary targets.

Other elements of the SEC's climate disclosure proposal would require reporting on:

- The scope of activities and emissions included in the target;
- The unit of measurement, including whether the target is absolute or intensity-based;
- The defined time horizon by which the target is intended to be achieved, and whether the time horizon is consistent with one or more goals established by a climate-related treaty, law, regulation, policy, or organization;
- The defined baseline time period and baseline emissions against which progress will be tracked with a consistent base year set for multiple targets;
- Any interim targets set by the company;
- How the company intends to meet its climate-related targets or goals;

- If a company uses carbon offsets or Renewable Energy Credits (REC)[1] in its plan to meet targets and goals, there would need to be disclosure about the amount of carbon reduction represented, the source of the offsets or RECs, a description and location of the underlying projects and the cost of the offsets or RECs; and
- How the board sets climate-related targets or goals and oversees progress against those targets or goals, including the establishment of any interim targets or goals.

Beyond the SEC's proposal, you should keep abreast of other industry standards and frameworks, including:

- **Regulators** – The International Sustainability Standards Board (ISSB) is a standard-setting body established in 2021 under the direction of the IFRS Foundation, whose mandate is the creation and development of sustainability-related financial reporting standards to meet investor needs for sustainability reporting. The ISSB is expected to finalize a set of standards in 2023 and the SEC is expected to work from ISSB's standards.

- **Rating Agencies** – There are numerous rating agencies that investors use to help them determine whether to invest in your company and what level of commitment is appropriate. CDP and the Dow Jones Sustainability Index are organizations that rate companies only if the company completes their questionnaire. Others, such as MSCI, ISS ESG, ISS QualityScore, and Sustainalytics, create assessments of your company based on publicly available information.

- **Institutional Investors** – Institutional investors have their own investing guidelines, as well as voting policies. You will need to maintain current information of changes in stewardship & voting policies of the investors that are important to you. You may also receive requests for information from investor coalitions. It's always in your best interest to talk to them, as it may head off a shareholder proposal down the road.

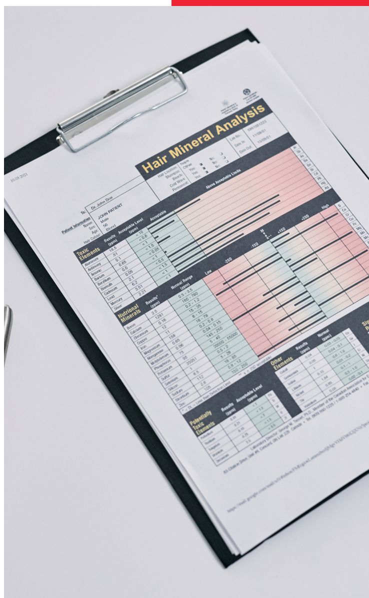
- **Industry Trends & Peers** – Participate in forums within your industry to keep abreast of trends that impact your industry, and read disclosures made by peer companies to ascertain what their goals and metrics are as well as how they're progressing.

When deciding which metrics and targets to use, you'll need to consider what type of information you'll be required to publicly disclose. The concept of "materiality" plays into that and we'll dig into that complex concept in our next chapter.

Renewable Energy Credit – a tradeable, market-based instrument that represents the legal property rights to the "renewable-ness"—or non-power (i.e., environmental) attributes—of renewable electricity generation. (Source link)

PART IV

MATERIALITY ASSESSMENT



Companies undertake ESG "materiality" assessments to identify pertinent ESG disclosures that might be material to a reasonable investor, inform stakeholders on relevant information, and advise ESG teams on how to better execute business strategy. They are a crucial first-step to the reporting process, and help internal teams focus on what matters.

Financial Materiality

The SEC's final rules on climate disclosure, expected to emerge in the second quarter of 2023, likely won't disturb the "financial materiality" concept that practitioners have long been acquainted with.

The SEC's rule proposal last year focused on "financial materiality," defined as "information that can have an impact on public companies' financial performance or position and may be material to investors in making investment or voting decisions." The SEC did not explore the notions of "double," "dynamic," and "nested" materiality in its rule proposal – likely due to the looming spectre of a legal challenge over its authority to do so. However, you should be familiar with these alternative definitions as global regulators and stakeholders may ask you to provide climate disclosures beyond "financial materiality."

- **Single materiality** is inwardly focused: "how does this impact the company?"
- **Double materiality** is both inwardly and outwardly focused: "how does this impact the company as well as our stakeholders?"
- **Nested materiality** essentially is a hybrid of the single and double materiality standards.
- **Dynamic materiality** is materiality that may be changeable or fluid over time.

“Reasonable Investor”

The input of your independent auditors when making a materiality determination is invaluable, as well as inevitable in most cases. The auditors will be applying the SEC’s Staff Accounting Bulletin No. 99 – and this statement last year from the SEC’s Chief Accountant is a good primer on how to apply SAB 99.

The financial materiality analysis is made through the lens of a “reasonable investor.” This is can be an elusive threshold because materiality determinations are challenged with the benefit of hindsight. What might seem reasonable to you might not to a court tasked with deciding whether your materiality determination is actionable.

What type of ESG information does a “reasonable investor” react to? Stock price movements aren’t the final word when analyzing which disclosures are material, but they can be instructive. A recent study – “Which Corporate ESG News Does the Market React To?” conducted by George Serafeim and Aaron Yoon found that stock prices react only to industry-specific financially material ESG news, and the reaction is larger for news that is positive, receives more news coverage, and relates to social capital (relative to natural or human capital) issues.

There are many reasons to disclose all material ESG information publicly. Investors might use a company’s ESG disclosures (or lack thereof) to help them determine whether to submit a shareholder proposal to that company. A company’s ESG disclosures could lead investors, and stakeholders, to undertake an activist campaign against management.

Line-Item Requirements

In addition to the judicial “reasonable investor” threshold, there are a number of line-item requirements in the SEC’s regulations that elicit ESG disclosures. In other words, companies are required to make these types of ESG disclosures even though a reasonable investor might not deem them to be material. In a sense, the SEC’s mandated rules make them de facto material.

When the SEC adopts final climate disclosure rules in the near future, there will be a host of these line-item requirements in the climate arena. Proposed new Item 1501 and 1502 of Regulation S-K has a host of various climate-related requirements ranging from assessing “physical risks” and “transition risks” to carbon offsets and internal carbon pricing. As noted in this Reuters’ article, companies should be planning their data strategy now to meet the coming line-item requirements.

The SEC bolstered rules that have resulted in more social disclosures, particularly focusing on human capital and board diversity, and will be proposing new rules for human capital disclosures by the end of 2023. Since the Sarbanes-Oxley Act and Enron, there has been an extensive list of governance line-item requirements that will surface in the coming years.

Protecting Yourself

Protecting yourself when making a materiality decision is key, particularly when not disclosing something. A misleading disclosure can pose trouble, but an omitted disclosure can have serious consequences. It is essential to identify a system of feedback from leadership when determining which disclosures to fulfill.

When internal disclosure controls are being implemented with an applied financial materiality analysis, there is an inherent heightened risk. Having proper resources to ensure you are properly navigating these new processes is essential for success.

How ZMH Advisors Can Help Your Company

By leveraging our technology and ESG expertise, ZMH Advisors helps companies overcome these challenges and assemble the appropriate teams to create effective ESG programs. ZMH offers a low cost, turn-key solution with an approach that focuses on:

- Mapping your company's current ESG profile against the SEC's baseline disclosure requirements to identify potential gaps (our "Baseline Assessment");
- Identifying your company's appropriate internal resources and expertise with the goal of addressing any gaps in disclosures;
- Helping to develop your TCFD, Scope 1 and 2 emissions, and other disclosures to assist in meeting the SEC's minimum expected disclosure requirement; and
- Conducting a comprehensive ESG Materiality Assessment in order to better understand what your various stakeholders deem material to your company.

Schedule a Call