The environmental, social, and governance (ESG) approach to corporate sustainability is becoming an essential part of business strategies in creating enterprise value.

The Business Case for Sustainability Initiatives: Focus on ESG to Create Enterprise Value

April 2021

Written by: Bjoern Stengel, Senior Research Analyst, Worldwide Business Consulting and Sustainability/ESG Services, and Laura Becker, Research Manager, Employee Experience and Sustainability/ESG Services

AT A GLANCE

WHAT'S IMPORTANT

Sustainability — and ESG specifically — is a new business imperative. It is a rapidly maturing space likely to be embedded across the organization in a relatively short time frame. Sustainable business strategies that measure and assess corporate performance across predetermined priorities with ESG metrics are no longer "nice to have" items; rather, they are necessary to create enterprise value. The lack of common, universally applied standards and frameworks limits the ability to meet investor requirements. Investors need consistent reporting and data to make informed decisions. Companies that provide these metrics will gain competitive advantage.

Introduction: The Rise of ESG

The character of corporate sustainability has changed significantly over the past few years. Many enterprises are in the process of moving from a mainly philanthropically focused approach to a more integrated, metrics-driven way of looking at sustainability, linking sustainability efforts to business outcomes. Environmental, social, and governance (ESG) approaches allow organizations to become more strategic about their sustainability efforts, which can help them improve operational and financial performance, risk profiles, employee attraction and retention, brand value, and more.

The concept of ESG as an approach to corporate social responsibility began as an investor-driven attempt to identify sustainability-related topics and issues (nonfinancial value drivers) that can ultimately affect corporate performance but that are not being accounted for in traditional financial statements. Investors increasingly saw that companies with a strong ESG performance tended to perform better financially. ESG's foundation consists of the use of data and metrics to measure performance across the three pillars, common ESG standards and frameworks to compare ESG performance, a focus on ESG materiality, and an industry-specific set of relevant issues. ESG is often synonymously used as a corporate approach to sustainability that includes a broader focus on corporate stakeholders beyond investors, including employees and customers, among others.

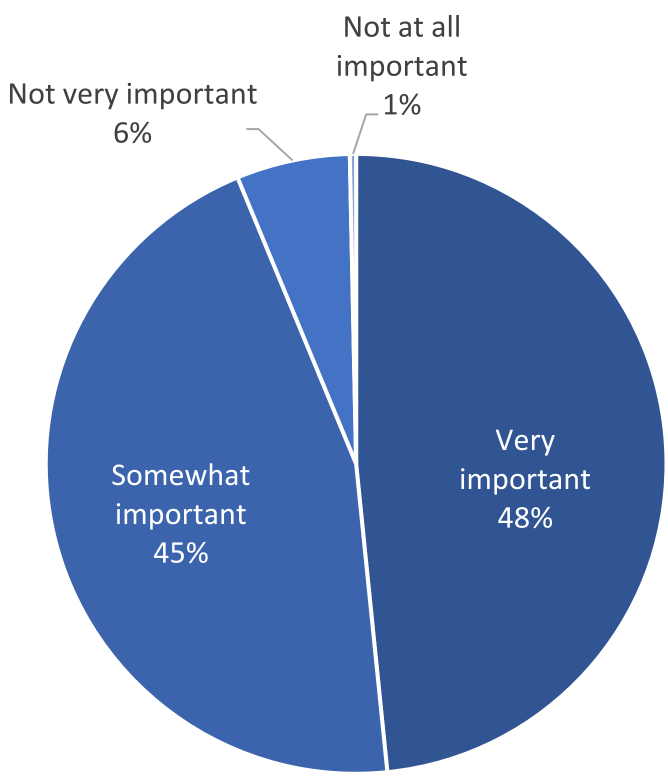
Investor Focus on ESG Drives CEO/Board-Level Focus

IDC's research shows that sustainability/ESG has been elevated to a CEO/CFO-level topic. This movement constitutes a change compared with previous views on corporate sustainability, and it highlights the level of coordination necessary among members of the C-suite and board to ensure adoption of a successful sustainable business strategy as ESG becomes an organizationwide initiative.

Sustainability has important implications for enterprises because it influences both operational and financial performance. Nonfinancial value drivers have been gaining in importance given that macroeconomic trends such as population growth, globalization, digital transformation, climate change, and talent scarcity have direct effects on business performance and enterprise value. Sustainability/ESG is considered "very important" by nearly 50% of respondents surveyed by IDC, as shown in Figure 1.

FIGURE 1: ***Where Organizations Rank Sustainability/ESG***

Q ***How important do you consider sustainability/ESG for the enterprise value of your organization?***



n = 635

Source: IDC's ESG Services End-User Survey, 2020

Organizations are being held accountable for sustainability for both financial and nonfinancial performance. ESG provides a mechanism for investors to evaluate corporate performance in this area in a more standardized way.

However, ESG is rapidly maturing, and companies are facing many challenges in terms of the variety of existing reporting standards and frameworks, which can make standardization and comparisons difficult. Many companies have joined the sustainability "movement," but in many cases, sustainability reports are still being used as marketing material rather than as transparency- and disclosure-focused documents that help investors obtain an objective view of companies' ESG performance.

While companies are aligning their sustainability efforts with purpose-driven goals by using more standardized, metrics-driven, and materiality-focused approaches, some organizations are still using non-ESG based, "doing good" language in disclosing these efforts, which makes it difficult to hold enterprises accountable.

This is where ESG-driven topics, measurement, assessment, and metrics become critical pieces of the approach to ensure positive business impact on the relationship between product, process, supply chain performance, and overall enterprise value, helping provide meaningful insight to the investor community.

Assessing Existing ESG Frameworks and Standards: An Evolving, Fast-Moving Approach

ESG approaches aim at making sustainability performance measurable and comparable. The current lack of a common, universally applied standard limits the ability of organizations to meet investor requirements.

Some of the most commonly used ESG standards and frameworks include those issued by the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI). The World Economic Forum (WEF) also released a new list of reporting metrics and disclosure standards (developed in conjunction with the Big Four accounting firms: Deloitte, EY, KPMG, and PwC). In addition, frameworks such as the UN Sustainable Development Goals (SDGs) and Task Force on Climate-related Financial Disclosures (TCFD) are helpful to organizations establishing specific business goals and initiatives.

However, there is movement toward more accountability and standardization. Companies are starting to combine different standards and frameworks (e.g., SASB, which is investor focused, and GRI, which focuses on a larger set of stakeholders). Consolidation efforts are also underway between the different issuing organizations. In November 2020, SASB and the International Integrated Reporting Council (IIRC) announced the intention to create a unified organization, the Value Reporting Foundation, by mid-2021. The impetus for this action is to create an international, integrated reporting framework for sustainability disclosure standards to enable enterprise value creation. A week after the Big Four accounting firms released metrics created with WEF, five ESG standard setters — the Carbon Disclosure Project, the Climate Disclosure Standards Board, GRI, IIRC, and SASB — said that they would work more closely together to align standards and frameworks after being urged to do so by international securities regulators. The path toward more aligned, unified standards continues to evolve and mature as investors and regulators ask for consistent, comprehensive, and verifiable data.

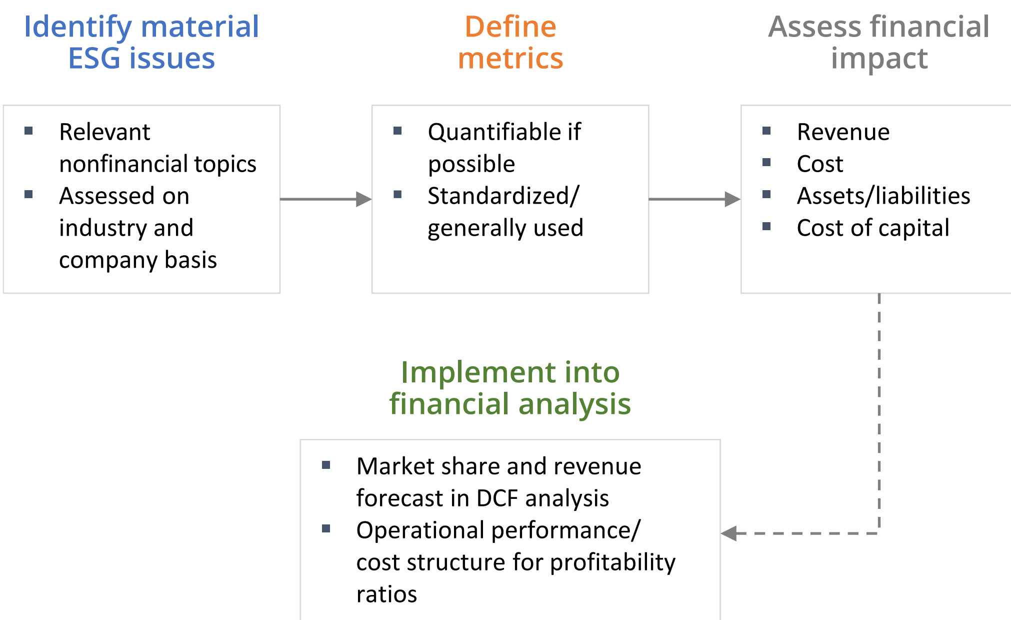
This is a very fast-moving space. In late 1Q21, the International Financial Reporting Standards (IFRS) Foundation announced an initiative to oversee the advancement of a standardized approach by setting up a working group to prepare for a potential international sustainability standard board. Both WEF and SASB issued statements supporting, in principle, efforts to establish a globally accepted system for corporate sustainability disclosures. The initiatives are endorsed by the International Organization of Securities Commissions and the International Federation of Accountants.

Increased data availability and transparency in reporting will enable investors to understand how new areas of safety, sustainability, and trust directly impact enterprise value.

Incorporating ESG into Valuation Approaches

Large institutional investors are moving toward integrating ESG considerations into their valuation practices, a shift driven by the growing importance of intangible assets and the attention that nonfinancial topics receive from various stakeholders. Intangibles such as a company's intellectual capital, customer relationships, and brand value vis-à-vis its employees and consumers are affecting valuations, requiring companies to find appropriate ESG metrics for the sustainability topics that matter to their business. Figure 2 depicts how ESG provides a way to lower risk and capture opportunities through sustainable business practices while following a purpose-driven path that can improve both financial and operational performance.

FIGURE 2: ***Lowering Risk and Capturing Opportunities with ESG***



Source: SASB and IDC, 2021

The handling of ESG issues (greenhouse gas emissions, water usage, diversity and inclusion, and product quality and safety, among others) can affect business performance in different ways, such as impacting revenue growth (demand for products and services), cost (operational efficiency), assets and liabilities (valuation), or cost of capital (operational risks).

ESG Prioritizes a Focus on Product Attributes to Create Enterprise Value

The ESG discussion of product focuses on the concerns that relate to systemwide environmental or social considerations. SASB standards identify the subset of environmental, social, and governance issues most relevant to financial performance in each of 77 industries to help companies disclose sustainability information that is financially material to investors.

SASB standards are useful to understand what is considered material (see Figure 3). In developing its 77 industry specific standards, SASB identified topics aligned with five dimensions (Environment, Social Capital, Leadership & Governance, Business Model & Innovation and Human Capital) and 26 broad sustainability issues. Specific product-level factors are highlighted in the red boxes for emphasis; other factors also relate to the operating environment and systems in which product is produced.

Just like the subset of sustainability issues covered in any individual standard, the product-level factors addressed in SASB accounting metrics are tailored to each industry's specific context. For example, products that qualify for credits in sustainable building design and construction certifications will be relevant to construction materials.

FIGURE 3: ***SASB Product Standards***

Environment

- GHG Emissions
- Air Quality
- Energy Management
- Water & Wastewater Management
- Waste & Hazardous Materials Management
- Ecological Impacts

Social Capital

- Human Rights & Community Relations
- Customer Privacy
- Data Security
- Access & Affordability
- Product Quality & Safety
- Customer Welfare
- Selling Practices & Product Labeling

Leadership & Governance

- Business Ethics
- Competitive Behavior
- Management of the Legal & Regulatory Environment
- Critical Incident Risk Management
- Systemic Risk Management

Human Capital

- Labor Practices
- Employee Health & Safety
- Employee Engagement, Diversity & Inclusion

Business Model & Innovation

- Product Design & Lifecycle Management
- Business Model Resilience
- Supply Chain Management
- Materials Sourcing & Efficiency
- Physical Impacts of Climate Change

Source: SASB and IDC, 2021

Third-Party Testing, Certification, and Validation Services Can Enable Better ESG Reporting

Given the amount of uncertainty around systematic, evidence-based reporting, as well as the growth of regulatory requirements, IDC's research shows an increasing demand for third-party assurance, certification, and labeling services. These services can help external stakeholders such as investors make informed decisions while providing corporate decision makers with confidence in their organization's ESG reporting. They also help indicate that a product has undergone rigorous scientific testing or exhaustive auditing, or both, to prove its compliance with stringent third-party performance standards.

Concrete examples of testing validation include ensuring the integration of engineering safety into products during the development process, checking for chemical content issues, and sampling indoor air quality. These testing validation processes can assist organizations in creating safer products with less risk and greater security while moving toward sustainability targets.

Disclosing Third-Party Testing and Certification Results

In the product testing and certification area, there are SASB standards and accounting metrics that ask organizations to disclose revenue earned from third party–certified products. Testing validation applies to dozens of industries and products, including appliances, batteries, beauty and personal care, components, consumer packaged goods, furniture, general merchandise, HVACR, household and industrial cleaners, lighting, medical devices, OTC and dietary supplements, textiles, apparel and footwear, toys and children's products, water and plumbing, and wire and cable.

For example, SASB's Multiline and Specialty Retailers Distributors Standard states that, "A product with third-party certification shall be considered certified regardless of what level or tier of certification it received. Third-party certification is defined as review by an independent organization that determines that the final product complies with specific standards. The scope of disclosure includes third-party certifications that are based on either environmental or social best practices or both environmental and social best practices."

Internal and External Ways of Assessing, Measuring, and Proving Performance

Investors need comprehensive, verifiable data, and the trend toward harmonization in the standards and frameworks space will be essential to the maturation of ESG reporting. There will be a growing need for the following ESG services particularly around these areas:

- Digital-enabled technologies that drive efficiency and improve data integrity to track critical ESG metrics such as carbon emissions, supply chain and sourcing data, waste, and energy use
- ESG advisory services such as consulting, financial advisory, and tax services
- ESG assurance and auditing services
- Product testing, certification, and validation that contribute to ESG metrics and frameworks such as multi-attribute sustainability standards for products or emissions certifications for products

Considerations

As we move toward a stakeholder economy, companies' performance on sustainability-related topics increasingly affects their financial performance as well. The ESG investing space is quickly maturing, but it is currently lacking a model for integrated, centralized standards and frameworks. ESG testing, validation, and certification can be helpful for investors and corporations alike to overcome uncertainties in the context of ESG reporting. Although the landscape continues to evolve toward a more unified approach, companies are still left to decide if and how they want to blend materiality-focused standards and frameworks with multistakeholder standards and frameworks to provide disclosure on consumer-oriented topics such as product quality, safety, and labeling, as well as customer welfare. These are areas where advisory, testing, and certifications can be of great benefit to enterprises as they cull data for investors.

Conclusion

The complexity and multifaceted character of ESG requires companies to take a comprehensive, end-to-end approach that considers various aspects of sustainability (e.g., geographical and industry-specific differences, normative and business-driven implications, internal and external stakeholders) and their impact on the different business functions. Sustainability has become a new business imperative. It will be ingrained into everything that businesses do, and it cannot and should not be seen as a separate or "nice to have" item any longer. Finding the right services to ensure standardized, consistent use of frameworks and assessments will help separate enterprise winners from losers by providing deeper guidance to the investor community.

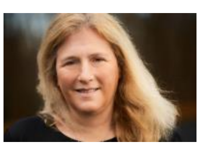
Sustainability is a new business imperative. ESG metrics can drive investor decisions and create enterprise value.

About the Analysts

Bjoern Stengel, *Senior Research Analyst, Worldwide Business Consulting and Sustainability/ESG Services*

Bjoern Stengel is a Senior Research Analyst for IDC's Worldwide Services Research Group. His research focuses on the business consulting services market, analyzing key trends for strategy; supply chain and operations; finance and accounting; governance, risk, and compliance; and people and organization consulting services.

Bjoern also leads IDC's Environmental, Social, and Governance (ESG) business services research, assessing how business services providers and their ecosystem partners can leverage sustainability/ESG to help clients drive business outcomes by better understanding the needs of various stakeholders (e.g., investors, regulators, employees, customers, and the C-suite) and ESG materiality.



Laura Becker, *Research Manager, Employee Experience and Sustainability/ESG Services*

Laura Becker is a Research Manager in the Worldwide Services Group focusing on employee experience (EX) and the specific areas of employee engagement/listening (voice of the employee); diversity, inclusion, equity and belonging; well-being (mental, physical, financial); recognition and rewards; digital EX; and other benefits that empower employees as key organizational stakeholders, and optimize business impact.

Laura also co-leads IDC's Environmental, Social, and Governance (ESG) Business Services program, assessing how business services providers and their ecosystem partners can leverage sustainability/ESG to help clients drive business outcomes by better understanding the needs of various stakeholders (e.g., investors, regulators, employees, customers, and the C-suite) and ESG materiality.

MESSAGE FROM THE SPONSOR

As the global safety science leader, UL helps companies to demonstrate safety, enhance sustainability, strengthen security, deliver quality, manage risk and achieve regulatory compliance. UL helps companies achieve their sustainability goals through solutions such as ESG and GHG tracking software, sustainability advisory, circularity solutions and product and facility sustainability certifications and validation programs. Our sustainable product offerings include our flagship ecolabels, UL ECOLOGO® Certification, UL GREENGUARD and Environmental Product Declarations as well as Environmental Claim Validation (ECV) for recycled content and more.

To learn more, visit UL.com/environment

IDC Custom Solutions

The content in this paper was adapted from existing IDC research published on www.idc.com.

IDC Research, Inc.
140 Kendrick Street
Building B
Needham, MA 02494, USA
T 508.872.8200
F 508.935.4015
Twitter @IDC
idc-insights-community.com
www.idc.com