By: Guest Writer
PUBLISHED: 24 March, 2022

INSIGHT

Get your portfolio ready for ESG reporting

Sustainability reporting is not window dressing, nor is it a marketing exercise. Similar to financial reporting, ESG reporting needs to be a data-driven process.

By Sean Gleason and Rob Gould, Protiviti

With US$35 trillion (per Bloomberg) poured into ESG-driven funds so far, sustainable investing has moved from the fringes to the front lines. Although ESG swept into private equity firms and investment houses with a bang, over the long term the spotlight will be focused more on how an organization is validating its (and its portfolio's) ESG footprint – through reliable data and reporting.

More investors and stakeholders are judging PE firms based on how well they build ESG into their management company and portfolios in an industry-specific manner. So, embedding ESG into the fabric of every management company and its portfolio companies – and, just as important, having the data to prove it – is paramount. PE firms are in a unique position because not only are they responsible for ESG reporting internally, but they also have an interest in reporting ESG data from their portfolio companies. Portfolio companies' consumers and customers – and, by default, PE investors – are watching, and they will continue to demand more.

ESG complexity

Investors increasingly are choosing to invest only in ESG-friendly companies. Similarly, growing numbers of consumers are doing business only with ESG-friendly organizations. ESG has become so integral that in the operational due diligence space, incomplete or below-par ESG practices and reporting can devalue an investment – while a strong ESG framework can increase it. ESG stakeholders demand ESG accountability.

But many variables make ESG reporting tricky. Portfolio companies come from a cornucopia of industries. Nailing down standardized reporting across a management company and its portfolio companies, collecting the right data, and arranging it in ways that build full transparency into ESG reporting are complex tasks.

Build it and they will come

Sustainability reporting is not window dressing, nor is it a marketing exercise. Similar to financial reporting, ESG reporting needs to be a data-driven process that relies on accountability – a book of truth.

As a first step, PE firms should consider stakeholder expectations. In their portfolio companies, they should take into account market or private investors. And for the PE firms themselves, they should pay the same consideration to stakeholder expectations. Ask questions such as "What are we driving toward? What is being required of us?" Based on the answers, PE firms should form a broad ESG strategy and then a portfolio company-specific strategy that can adapt based on industry uniqueness. Depending on its industry, an organization may have different needs, reporting frameworks and data sets, as well as different processes for gathering that data.

Next, PE firms must weigh the risks and opportunities to determine appropriate ESG strategies for each entity in their portfolios as well as their management company. Performing an ESG gap assessment will shine a light on current areas for improvement in comparison to where they want to be. However, they will need to decide the extent of ESG data-gathering and reporting sophistication they are willing to fund and how much their stakeholders will demand.

Once a gap assessment is conducted, building and refining the right infrastructure to fulfill the chosen ESG reporting strategy is vital. It is important to determine how ESG reporting can be integrated into processes and standards that a management company and its portfolio companies may already have in place – for example, for financial reporting purposes – so that the infrastructure is not something that is completely new. The overall infrastructure should not require building from the ground floor up.

Once the ESG strategy is defined, the seven core elements needed for a strong ESG infrastructure are not going to change. They are: policies; processes; people and organization; reports; methodologies and assumptions; systems and data; frameworks.

Data versus greenwashing

Accusations of greenwashing can result in irreparable damage to an organization. Thus, ESG reports and declarations must be supported with the right data. Data is all about documenting, substantiating and supporting ESG initiatives. It fuels the book of quantifiable truth – and proof – for an organization's ESG mission. In addition, establishing a reporting structure and converting the data into a usable, structured format for documentation is essential. That way, all reports and statements related to ESG and sustainability are fully supported.

Be forward-looking

While the European Union is an indicator of a future ESG state, in the US, the SEC is contemplating what future ESG regulatory requirements might look like, and revisiting requirements already in place for climate change disclosures. Globally, different countries and regions have differing requirements. However, formal regulatory mandates may be a moot point when it comes to the significant role of ESG in any organization. Various stakeholders, from the world's largest asset managers and beyond, will continue to drive ESG priorities. It is up to PE firms to champion ESG reporting infrastructures that can meet current and future stakeholder and regulatory expectations.

Sean Gleason and Rob Gould are managing directors at Protiviti, a global consulting firm specializing in internal audit, risk and compliance and business processes.