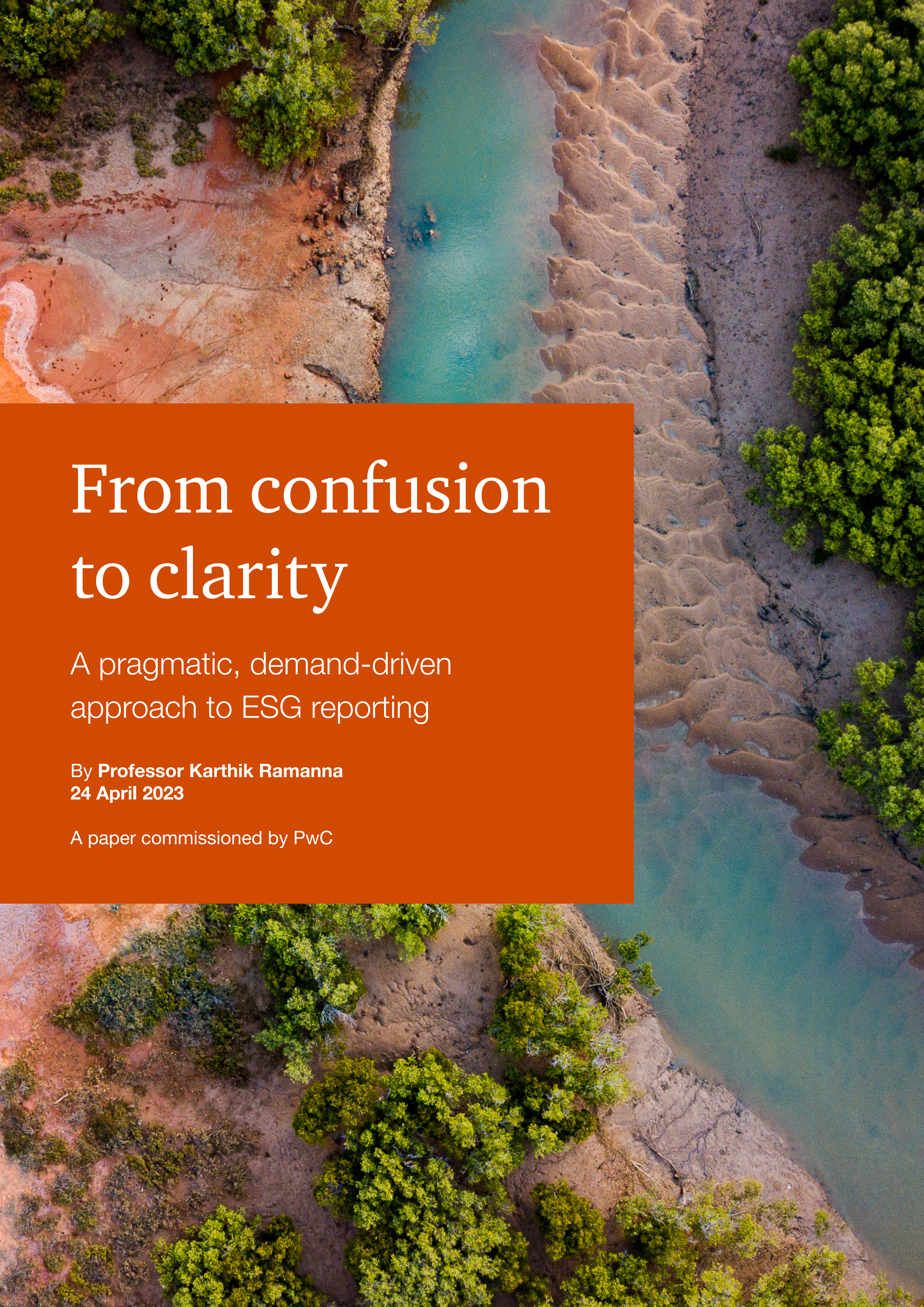


From confusion to clarity

A pragmatic, demand-driven approach to ESG reporting

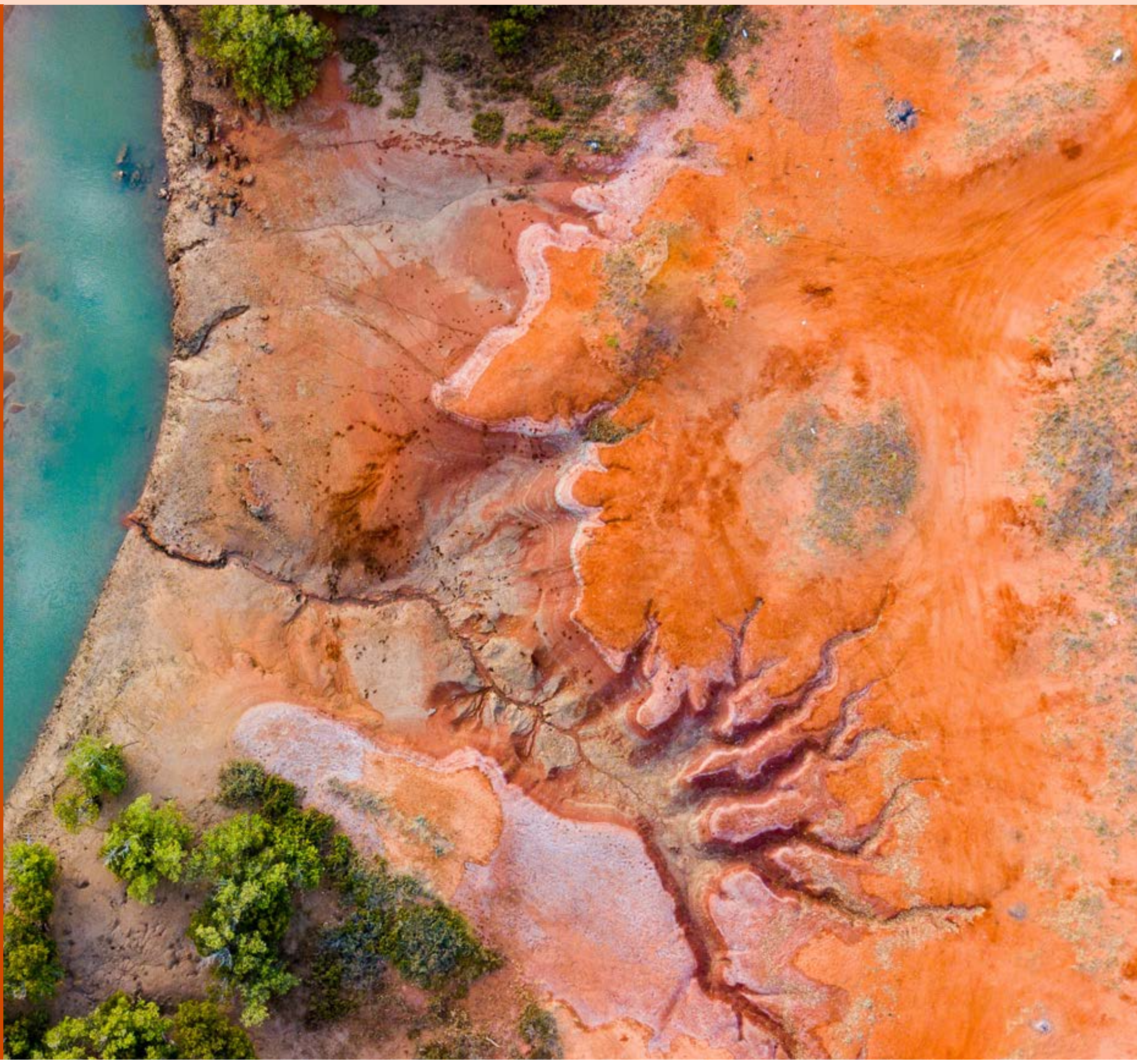
By **Professor Karthik Ramanna**
24 April 2023

A paper commissioned by PwC

Between November 2022 and February 2023, Professor Karthik Ramanna held a series of informal meetings with various economic stakeholders globally on what they saw as the challenges and opportunities of corporate ESG reporting.

The meetings, which were mainly organised by PwC[1], included participants from the preparer community (corporations listed and unlisted, large and small), as well as those from the asset-management and NGO worlds. Preparer participants held a variety of roles, ranging from reporting to finance to purchasing to general management, while other participants also represented a range of perspectives: from buy-side and sell-side; from pro-capitalism to market sceptics.

All participants spoke from their substantial professional experience, and the conversations were intentionally casual, to allow participants to speak freely and not be hewn to their employers' official positions. From these meetings, Professor Ramanna sought to infer what stakeholders actually want to see in corporate ESG statements. This paper gathers learnings from the meetings to develop an approach to corporate ESG reporting that is pragmatic and demand driven.



[1]"PwC" refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

The findings, interpretations, and conclusions expressed herein are those of the author and do not necessarily reflect the views of PwC.

Executive overview

The punchline to this report's findings is that despite the voluminous amount of corporate ESG disclosure today, few stakeholders see it as being of core strategic value. In fact, the term most used to describe the current state of ESG is "confusion." But there appears to be more focused demand for accounting data on certain ESG domains, like GHG emissions, with the precise domains demanded likely varying across companies and industries.

With this basis, and given that ESG regulations, particularly in Europe, are nonetheless proliferating, I propose that companies complement any forthcoming mandatory ESG disclosure with more-strategic ESG accounting that responds to specific user demands amongst core constituencies such as B2B customers and end-consumers. This targeted ESG accounting can become a managerial value-add to companies, eventually generating competitive advantages and perhaps even greater profits. The report offers a pathway to this strategy.

I have organised this report into three parts. The **first section** lays out the context for ESG. Here, I note the broader political environment that has made ESG a household term, and I discuss the **fragmented understanding** across communities of what the term even means. I also consider the difficulties in associating ESG actions with financial returns, which creates issues for many businesses, even as they feel the heat to be seen as leading on ESG.

Layer onto this the coming big shifts in ESG standard-setting – notably with the EU's CSRD and the SEC's climate disclosure rules, and the expected divergences across these standards on core matters such as materiality – and companies are experiencing an environment of "confusion". With that background, I make four observations to ground corporate ESG action:

01 **It is unwise to materially ignore ESG demands** (i.e., don't do nothing, and don't just resort to greenwashing).

02 **Not all ESG is win-win**.

03 **Some ESG can be win-win** (but this is generally an uncertain proposition).

04 **Demand signals are useful guides for ESG action**.

The last observation, in particular, establishes the need for and value in developing a voluntary ESG reporting approach (i.e., complementary to regulatory requirements) that actively listens to and clarifies ESG demands across key stakeholders. The core to this approach is to use voluntary ESG reporting itself as an interactive tool to gauge where stakeholder interest lies across the spectrum of sometimes-competing ESG actions and then to home in on developing a competitive edge in those few domains.

Since active listening to stakeholders is a central theme to my approach, the **second section** then summarises my various stakeholder meetings, with a view toward illustrating what different users of ESG reports want. I note, soberingly, that many B2B **customers** and institutional **investors** do not have a first-order strategic interest in ESG reports as currently structured, seeing them instead as a check-the-box compliance activity. But I also highlight a core commercial demand for high-quality, rigorous ESG reporting that is aimed especially at a few targeted areas such as the decarbonisation of supply chains. I note how such demand can be expanded by bringing more actionable product-level ESG data to end-consumers, an opportunity for information intermediaries seeking to distil consumers' ESG sentiments into actual purchasing decisions. Among **corporate managers**, I identify a generally strong intrinsic commitment to engage authentically in ESG reporting, although they appear to want to do so in two broadly different ways: one camp would like to see ESG reporting home in on quantified data that is verifiable and representationally faithful; while the other would prefer ESG reporting to be more qualitative, less focused on accountability and more geared toward inspirational communication.

In the **third section**, I stake out a position in the ongoing ESG debate by weighing towards quantification. In effect, I make the **distinction between** "disclosure" and "accounting," noting that virtually all ESG efforts to date, including standard-setting efforts, are disclosure-based, whereas the demand and value-creation potential for ESG appears to lie in taking an accounting approach. I propose a three-step framework for corporate ESG accounting that responds to user demands.

- **First**, companies should pick three domains ("less is more") that are material to their key stakeholders as the basis for ESG accounting.

- **Second**, working with those stakeholders and with assurance practitioners and standard setters, they should embrace ESG accounting metrics on those domains that are accurate, comparable, and simple to understand.

- **Third**, companies should iterate and improve their ESG accounting through user feedback loops, using the feedback as a management-information tool to develop a competitive advantage on those domains. I propose that the supply of such useful ESG reporting can create its own enhanced demand, which, in turn, deepens the market forces that discipline such reporting so that it can drive real actions within companies where needed.

Eventually, this approach allows the company to expand ESG accounting to beyond the initial set of three domains, if there is legitimate demand for and value in doing so.

CHAPTER I

The context of ESG

The late economist Joan Robinson once noted, "Whatever you can rightly say about India, the opposite is also true." Having conducted an exhaustive set of in-depth meetings with corporate preparers, investors, customers, and activists, I think one can say the same about ESG.

Across these meetings, I heard nearly every conceivable argument about ESG, but also their opposites. I even heard that ESG reports need not be simple, comparable, or accurate – that, given the nature of ESG itself, the reports must be complex, idiosyncratic, and unverifiable. In fact, perhaps the observation my interviewees most agreed on was that the word best suited to describe what comes to mind when one hears the term ESG is "confusion."

Why the confusion? The problem with ESG today

The term ESG appears to date back to the early 2000s, to a UN-sponsored report that emerged in the wake of waning popularity of the term CSR, an acronym for corporate social responsibility. Whereas CSR explicitly referred to corporate duties in domains outside of incurred monetary costs and benefits (i.e., "externalities"), the UN report attempted to reframe such actions, under the ESG moniker, as having "a material impact on investment value" over "longer time horizons (10 years and beyond)." In effect, the emphasis was on risk management – where ESG activities are necessary to shareholders, to mitigate reputational or legal risks for the company, even if they don't lead to top-line growth. Moreover ESG, as a term, brought together three very different responsibilities – environmental, social, and governance – and, in the process, surfaced the added problem that these responsibilities, to which the UN report argued companies must be held, are sometimes contradictory and not fungible in any generally accepted sense.

The meaning of "ESG" is continuously evolving with political and economic shifts, making it difficult to define the term. As Nietzsche explained, "concepts that have histories cannot have definitions."

Since then, the meaning of the term ESG has evolved to also include so-called win-wins, rather than solely risk management. Put differently, ESG became a catch-all to reflect strategies of "long-term value creation" where companies could align profit with the interests of the planet and society.

Perhaps poetically, ESG today appears to be returning, especially amongst some in the American right, to its original "externalities" meaning. The idea of ESG has become politicised as "anti-capitalist" as, to some, it prompts companies to "waste" investor resources on activities that are outside the legitimate realm of the for-profit corporation. I heard that this sentiment has grown in favour as interest rates have risen and economic belts have tightened. Where ESG could once be "ignored" as a luxury of prosperous times, it is now, amongst detractors, seen as value destructive.

The differential understanding of ESG as a term is also witnessed in differential regulatory approaches to ESG reporting. Within the European Union, the Corporate Sustainability Reporting Directive has taken a multiple-materiality approach to such disclosures (see SIDEBAR), meaning that companies must report "not only on how sustainability issues might create financial risks for the company (financial materiality), but also on the company's own impacts on people and the environment (impact materiality)." This approach puts the EU's understanding of ESG closer to a CSR meaning. Meanwhile in the United States, the regulation of ESG reporting is generally seen within the narrower context of investor-protection mandates (i.e., the Securities Acts), and so ESG disclosures are expected to be, simply, financially material. The implication is that ESG is about long-term shareholder value. The latter is also the approach of the newly created International Sustainability Standards Board (ISSB), although the ISSB has embraced a much wider ESG scope than the SEC.

That the understanding of ESG has evolved, is continuously evolving (and diverging!), and has even come full circle suggests that it is a fool's errand to try to formally define the term. As Nietzsche explained (paraphrased by Quentin Skinner): "concepts that have histories cannot have definitions." ESG today, as always, means different things to different people.

Implications of the problem

Given the highly dynamic state of ESG regulation, and an emerging divergence between the EU and the US over what should motivate ESG reporting, this report stays agnostic on ESG definitions. Rather, my focus is pragmatic, offering an approach for managers to pursue ESG reporting in a manner that can help win friends, keep enemies placated, and identify and drive value. The pragmatic approach is sensible for firms navigating the uncertain regulatory landscape: for instance, even if US firms think they can escape "impact materiality" by virtue of the SEC's focus on "financial materiality," this is unlikely to be the case if they have significant European lines of business.

Following my approach is not intended to replace regulatory compliance. Indeed, where such compliance is necessary, it must be pursued. But, as I have heard in my meetings and will discuss shortly, ESG reporting for regulatory purposes is often seen as check-the-box and unconnected to business strategy. In contrast, my focus here is on offering an ESG reporting approach that can

Disclosure versus accounting

Most ESG reporting today takes the form of what I will refer to throughout this report as disclosure. Such disclosure is usually qualitative in nature, although it can include quantitative elements as well. What sets it apart is that it is not prepared according to generally accepted principles of accounting.

Accounting is the process of measuring and categorising (usually financial) information according to certain generally accepted principles that ensure that the information actually represents what it purports to. The accounting process is intended to generate a degree of comfort amongst users that the information is comprehensive (does not omit something material), reliable (e.g., objectively verifiable and prudent), and comparable (across peers and reporting periods). A shorthand for accounting versus disclosure in US SEC regulatory parlance is S-X versus S-K information, respectively. So, accounting, for purposes of this report, refers to (ESG equivalents of) financial statements and their footnotes prepared according to generally accepted principles, whereas disclosure refers to all other reporting on corporate (ESG) performance by an entity.

[Continued...]

identify and deliver value for at least some of those stakeholders who are demanding corporate ESG actions. The goal is for companies to transform (part of) their ESG reporting into a management-information tool.

Even if there is no definition for ESG, we can articulate here two general observations about ESG, which I heard across our meetings, that are both “non-trivial and true” (to quote Stanislaw Ulam’s criteria for useful knowledge).

01 **There are material social and political demands for companies to act on responsibilities outside of profit-making.**

02 **The strength of these demands varies substantively: for instance, across countries and regions, with company size and perceived profitability, with issue-area and macroeconomic conditions.**

These stylised facts have four important implications for corporate actions in the ESG space:

01 It is unwise to materially ignore ESG demands;

02 Not all ESG is win-win;

03 Some ESG can be win-win; and

04 Demand signals are useful guides for ESG action.

Let me expand.

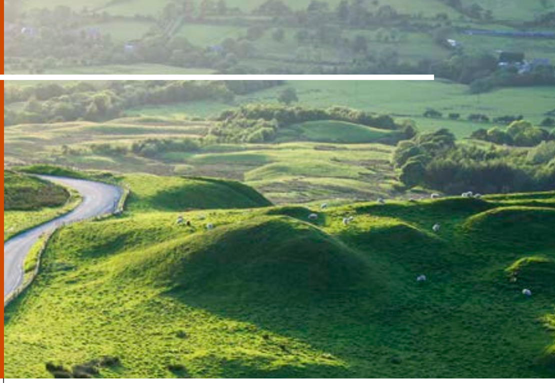
It is unwise to materially ignore ESG demands: The purpose of the corporation in society is a matter of longstanding debate. The shareholder capitalism view suggests that this purpose is to increase the present value of future cash flows to equity holders. The stakeholder capitalism view suggests that this purpose is more nuanced, and that the corporation has responsibilities to employees, customers, local communities, and so on, beyond that which is accomplished through profit-making and through compliance with prevailing laws and customs. While the precise scope and intensity of this debate vary across countries and time, the debate itself is alive today, within companies, in civil society, and in political discourse.

Here, I take no position on this debate other than to say to companies that it would be unwise to ignore that this debate is occurring. The implication is that there are unfulfilled expectations of companies from stakeholders beyond the need to deliver profits. A company that habitually ignores these expectations runs the risk of being outcompeted by rivals (for scarce employee-talent and customers), outmanoeuvred by regulators and activists, or, worse still, lose entirely its ethical and legal licence to operate.

If a company reports as *accounting* that its total cradle-to-gate carbon footprint is, say, 100 tCO_2e, then an auditor should be able to provide “reasonable assurance” that this number is within a non-material margin-of-error of the “true” emissions number, just as in a financial-statement audit. If a company reports as ESG *disclosure* that its total cradle-to-gate carbon footprint is 100 tCO_2e, then, for auditors to even accept to provide such reasonable assurance, they need to be first satisfied that several pre-conditions are present:

- That the subject matter is appropriate for assurance (for instance, that management has control over the subject matter, which is harder to establish for “downstream” emissions and ESG activities);
- That suitable criteria exist, or can be developed, for reasonably consistent measurement and evaluation of the subject matter (robust reporting standards usually provide such criteria);
- That sufficient, appropriate evidence is expected to be available to establish that information on the subject matter provided by the client is not materially misstated (e.g., relying on secondary data sources to estimate supply-chain emissions would make satisfying this pre-condition difficult).

Only upon establishing the presence of the above conditions can the auditors proceed with evaluating, to a level of reasonable assurance, whether the disclosure number is not materially different from the company’s true emissions. Disclosure without independent reasonable assurance is difficult to use for strategic resource-allocation decisions.



Put differently, every company must, even if only as a matter of business pragmatism, have an ESG strategy.

Not all ESG is win-win: The term ESG is widely used by various civil-society participants to focus companies on activities not directly covered by profit-seeking. These include activities to reduce environmental pollution, end the use of modern slavery and child-labour practices, reduce workplace harms, and advance a diverse, multi-cultural workforce (directly and in supply chains). True, some of these activities could, over time, for certain companies in certain jurisdictions and sectors, be a conduit to further profit-making. But equally, for other companies, such activities would simply remain corporate social responsibilities. Moreover, ESG activities include being a responsible taxpayer that does not engage in tax-avoidance strategies and a responsible corporate citizen that does not lobby for self-serving regulations. Both such activities, while laudable ethically, are likely to leave shareholders with smaller financial returns.

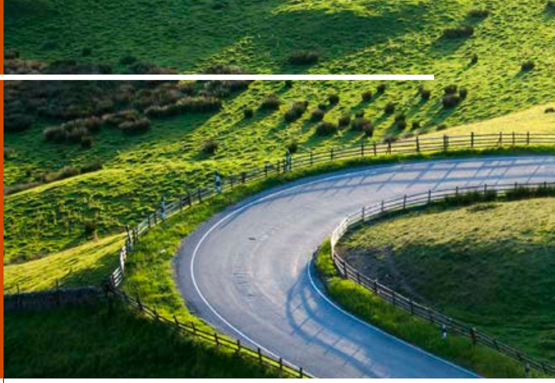
So, not all ESG is a win-win, despite rhetoric to the contrary from "sustainable capitalism" cheerleaders. **Even as companies must (pragmatically) engage in ESG, they must realistically recognise that some of it will be a pure cost.**

There is another implication here, not for business, but for governments and public policy: If not all ESG is a win-win, then the premise that ESG aims can be accomplished through voluntary corporate action alone is incorrect. Governments wanting material compliance with certain ESG aims (e.g., pollution control) are then advised to promulgate appropriate regulations. To the extent that such aims involve securing "negative freedoms" such as eliminating indentured labour, they can be effected through outright regulatory bans; to the extent that they encompass "positive freedoms" such as promoting a diverse workforce, they can be driven by setting measurable targets (and auditing progress toward them).

If not all ESG is a win-win, then the premise that ESG aims can be accomplished through voluntary corporate action alone is incorrect.

Indeed, several corporate executives I spoke with would even welcome such regulation by governments, even if only to provide clarity on what is expected of business in ESG areas that are not win-wins (and where civil-society activism can be noisy, arbitrary, and sometimes vitriolic). It is certainly in the interest of high-commitment businesses to have such across-the-board regulations since they would prevent such companies from being at a competitive disadvantage to low-commitment firms that do not currently opt into non-win-win ESG actions. Interestingly, governments themselves have shied away from such regulations, noting perhaps the political costs embedded in making them, as pursuing many ESG domains does come at the expense of (intermediate-term) economic growth.

Some ESG can be win-win: Even as some ESG activities will be a pure cost to business (albeit potentially a benefit to society), other ESG activities can be win-wins (i.e., a benefit to both business and society). Here, the sustainable-capitalism crew has done yeoman service in highlighting success stories and possible paths to reimagining business processes.



But I heard that win-wins often do not come easily: in fact, if they did, so much time and effort would not have to be devoted to point them out. In other words, the ESG win-wins are out there, but they are not always obvious, and realising them takes time and effort.

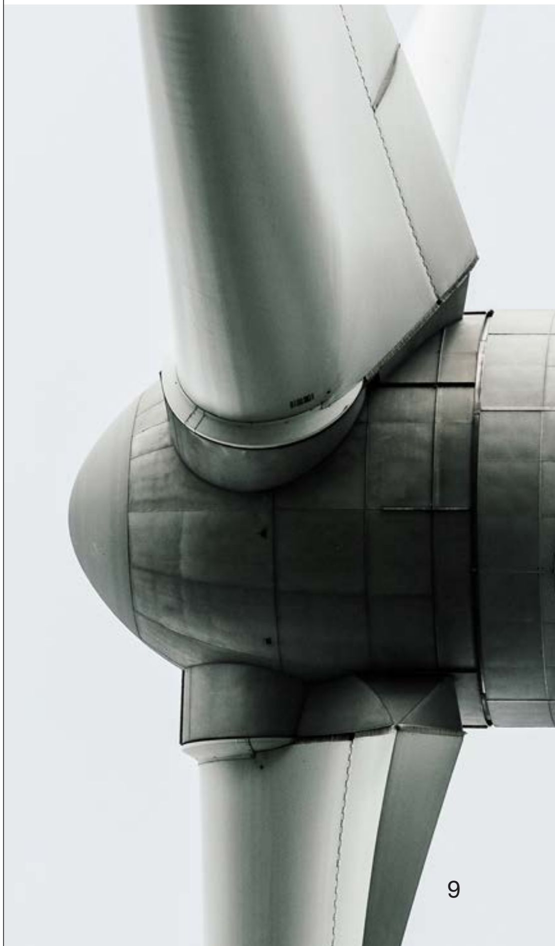
Organisational scholars have written about why companies often leave win-wins on the table, and these reasons usually boil down to two: lack of motivation and lack of inspiration. Lack of motivation means that managers know about the win-wins, but they don't care about them – perhaps because of the risk-reward structure of their own compensation or their own short-term horizons. Lack of inspiration means that managers don't know about the win-wins, or, even if they do, don't know how to go about realising them.

Upon asking corporate executives why they did not fully chase-up on ESG win-wins, elements of both reasons above were mentioned. Some executives noted that the demand signals for ESG win-wins, from investors and customers, were not always clear and strong. For instance, most investors of large companies are passive and take a relatively low-cost check-the-box compliance approach to driving ESG action. Active investors such as hedge funds, who primarily drive share-price movements, rarely focus on ESG win-wins. What is missing, therefore, is a large class of active ESG-focused asset managers who are willing to create, sometimes even through short-selling, sustained investor demand to motivate companies to pursue the often-long-horizon ESG win-wins.

Likewise, several executives pointed out that value-chain (B2B) customers often take a passive compliance approach to ESG and that end-consumer demand for ESG is highly variable, unpredictable, and fragmented. (An exception is following a media flare-up, for instance, a negative press article about modern slavery in the supply chain.) Even if customers and consumers really care about some specific ESG issues (e.g., dolphin-free value chains) and are willing to make purchasing decisions accordingly, they rarely know how to signal their preferences. Thus, few entities appear to face material demand-side pressure to re-build business models to be more ESG inclusive; it is quicker and easier to make money doing business as usual.

Even amongst executives who did face real demand-side pressures to deliver on ESG win-wins, there were concerns about how to do so. Smaller businesses, in particular, have less bandwidth to engage in strategic reimagination, and these businesses might well need public grants (e.g., from development banks) to pay for external consultants to set them on their ESG win-win journeys. While such grants may seem anathema to strict free-marketeers, they are not conceptually dissimilar to innovation grants that are part of the standard toolkit in public policy to stimulating entrepreneurial activity.

Amongst larger companies that do have dedicated ESG teams with the bandwidth to perceive ESG demand signals and to respond to them with new business strategies, the concern often expressed was that these teams usually sit apart from the true decision-makers (C-suiters) in the firm.



ESG teams in large companies may not be nested under the CEO or CFO, but rather seen as part of "supporting" functions such as corporate communications, philanthropy, and public relations.

> So, in a nutshell, even as there are ESG win-win opportunities, making them real will likely require more clarity and support from customers and investors, as well as more bandwidth and commitment from the C-suite and development-finance agencies.

Demand signals are useful guides for ESG action: Thus far, I have argued: that ESG, as a pragmatic matter, should not be materially ignored; that ESG is not always win-win; and that some ESG can be win-win, but getting there is hard. So, how then can a business make progress in this domain? The answer, somewhat paradoxically, is implicit in the substantial heterogeneity in ESG preferences across customers, investors, activists, governments, employees, and managers themselves. By tuning in to these varying demand signals, a company can ascertain where action is (urgently) needed to preserve its legitimacy and to sustain its profitability and where action is possible to grow its business. And this (fine) tuning is where (voluntary and strategic) ESG reporting can itself play a first-order role.

Many corporate managers I have encountered are intrinsically motivated to engage in ESG actions without malintent, that is, for some reason other than misrepresentation (such as greenwashing). Their reasons may vary – as previously noted, from pure altruism to risk management to win-wins – but regardless of these reasons, what managers appear to crave is a sense of "what should I focus on and how much of it should I do?" Focus on the wrong actions or do too little, and you lose your soul, your reputation, and your profits; do too much and you may end up in an ideological morass.

In the face of these dilemmas, demand signals can be useful calibrants for ESG action. Knowing what your stakeholders expect and aspire from you is critical intelligence to make sense of the ESG "confusion". Perhaps the greatest value in taking such a demand-driven approach is that ESG demands are not static. They vary across time (e.g., macroeconomic and environmental conditions) and place (e.g., emerging versus developed economies). So, what works in one year for one jurisdiction will not easily generalise. Moreover, get too far ahead of the local-temporal demand, and the company risks setting itself up for failure by overpromising relative to what is sustainably possible to deliver.

But several executives I spoke with noted that the ESG demand signals directed at companies are often weak, garbled, and conflicting. How, then, can a company know whom to listen to and in what domains?

Here, a company's own ESG reporting can provide a useful conduit for filtering signal from noise. Preparing an ESG report requires a company to commit in writing, under penalty of reputational and (increasingly) legal liability, to a course of ESG actions.

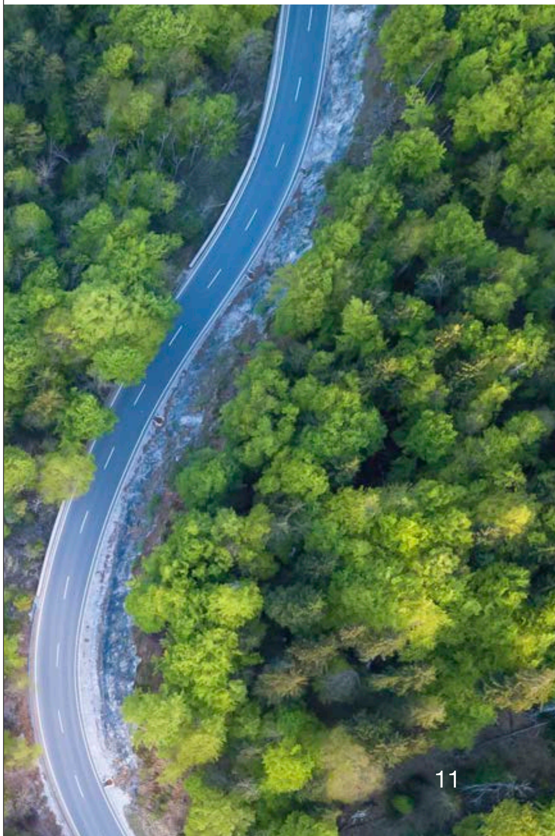
The report then serves as a basis for stakeholder engagement – activists may ask why certain actions are missing, investors may ask how the reported actions manage risks, and customers may ask how those actions generate product differentiation. These interactions, varying across time and place, themselves then generate impetus for less or more ESG across different domains like climate, diversity, and wages. Put differently, **the supply of ESG reporting can clarify (and indeed even amplify) demand for ESG action.**

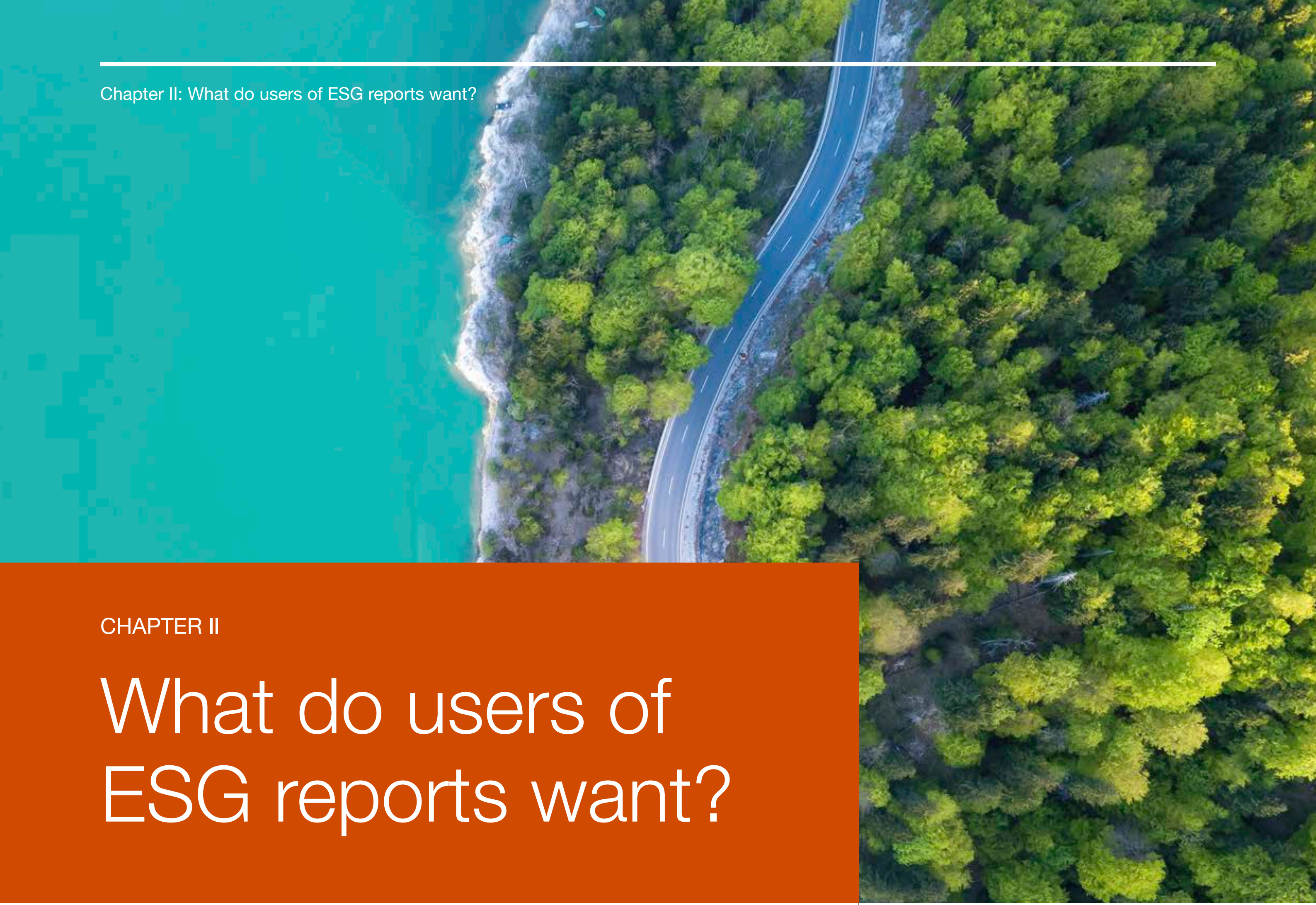
The implication is that companies must be more deliberate about their ESG reporting, thinking carefully about how they communicate, how such communication elicits engagement, and how they then iterate across successive communications. Thoughtful ESG reporting can become the beacon to navigate the din of noisy ESG demands, just as ESG demand signals themselves can bring order to ESG confusion in markets and society.

Thoughtful ESG reporting can become the beacon to navigate the din of noisy ESG demands.

I heard across several of our meetings that ESG reports today are too complex, idiosyncratic, and unreliable for decision-usefulness amongst stakeholders. Some ESG preparers within companies even pride themselves on the reports' lack of objectivity, seeing their outputs as abstract works of art, not for dynamic stakeholder interaction over resource-allocation decisions but for inspiration from afar.

To use ESG reporting as a tool to harness ESG demand signals, I posit such reporting must be simple (to read and understand), comparable (across peers and time), and accurate (i.e., representationally faithful and verifiable, preferably in a "true and fair" sense). These are (or at least should be!) uncontroversial reporting properties (not least because they mitigate liability), and I will say more on what this means concretely for companies later in the report. But, for now, I will point out that swathes of what is currently offered in terms of ESG reporting fail to meet these basic criteria. The good news then is that there are ample opportunities for corporate preparers, intermediaries, and regulators to improve the ecosystem around ESG reporting.





CHAPTER II

What do users of ESG reports want?

Here, I expand further on what I heard across various stakeholder meetings encompassing customers, investors, preparers, and activists.

In doing so, I have avoided taking a clinical approach to reporting verbatim from the interviews; rather, I have synthesised salient and frequently stated arguments into actionable narratives. I have also avoided direct attribution to honour the informal nature of my conversations with the stakeholders.

What ESG data do customers and consumers want to see? To the extent that we expect for-profit firms operating in competitive markets to voluntarily satisfy through their actions the broader public aims of ESG, end-consumers must be willing to pay for those actions. Put differently, if consumers do not spend on ESG, then ESG actions will be undersupplied by companies, absent regulation. After all, even supply-chain pressures on upstream companies from their customers, to perform on ESG domains, can be traced to (current or hypothesised) end-consumer demand for ESG. So, what ESG data do consumers want to see in making purchasing decisions? (NB: Throughout this report, “customer” refers to B2B buyers whereas “consumer” refers to individuals and households.)

In a nutshell, there is no generalisable answer. Instead, there is substantial heterogeneity amongst end-consumers on ESG preferences, with variance across geographies, macroeconomic and other temporal conditions, individual incomes and wealth, product categories (e.g., luxury versus basic goods), and even ESG domains (e.g., climate, water, modern-slavery, diversity, etc.). That there is a consumer market for ESG has been well-established, but how broad and deep and stable is this market is a matter for dynamic market-research.

For ESG data to be meaningful to end-consumers in buying decisions, I heard that it must be considerably simpler, more comparable, and more accurate than it currently is. Much of corporate ESG reporting currently focuses on the enterprise level, with product-level reporting seen as a disjointed marketing and branding exercise.

Moreover, contrary to financial reporting, enterprise-level ESG reports are created top-down, from industry and sectoral assumptions, rather than bottom-up by aggregating across features of products and transactions. All this contributes to the suspected lack of decision-usefulness of ESG reporting in end-consumer purchasing activity that I heard about. Few consumers, for instance, are thumbing through the dozens of pages of glossy stories seen in many corporate ESG reports.

What these observations suggest is that there is a wide-open opportunity for developing consumer-focused product-level ESG reporting. Like nutrition labelling on food items that serve as complementary data to prices in buying decisions, ESG labelling that accurately represents the features of a product or service can provide a basis for competitive differentiation and additional profit-making.

Of course, the domains of ESG are vast, ranging from CO_2 emissions to transgender equality, so companies will have to make strategic choices on which domains to highlight on which products to keep labelling simple. And, I heard, they cannot be too opportunistic about such choices, as consumers are already rather sceptical of ESG: for instance, a petrol company featuring its anti-child-labour accomplishments in its ESG product labelling, rather than its carbon footprint, is likely to invoke a cynical backlash from consumers. Put differently, **it appears that companies must focus on addressing responsibilities arising from their *asymmetric* capabilities, rather than more-general responsibilities, to be seen as ESG-credible with consumers** (see SIDEBAR).

The domains of ESG labelling will also need to be more consistent across competing products, to enable comparability for consumers, suggesting a greater role for standard-setting. Such standards can also then address concerns around the reliability of ESG product-labelling, yielding a common-minimum approach to verifiability of ESG data along supply chains. Interestingly, none of the major regulatory bodies have taken a material interest in consumer-focused ESG reporting, suggesting that there are openings for private initiatives such as rewired.earth to be impactful. Such initiatives can also provide market-

Asymmetric capabilities

"Capability" is defined as the state of being in a position to act in a given way. Asymmetric capability refers to the ethical imperative to act to alleviate harms from externalities when one has a positive-differential capability to do so.

The greater the underlying harm and the greater the positive-differential capability, the greater the imperative to act. For a company, asymmetric capabilities could emerge from possessing financial resources or relevant technologies that can alleviate the harm from externalities. See Managing in the Age of Outrage by Karthik Ramanna

research data to help companies and industries home in on the ESG domains that most matter to their current and prospective end-consumers.

If end-consumers have decision-useful ESG data, then the clarity of their purchasing preferences can travel up supply-chains from retailers to intermediate suppliers to primary producers. That is, better consumer-focused ESG reporting yields better B2B supply-chain ESG reporting as well.

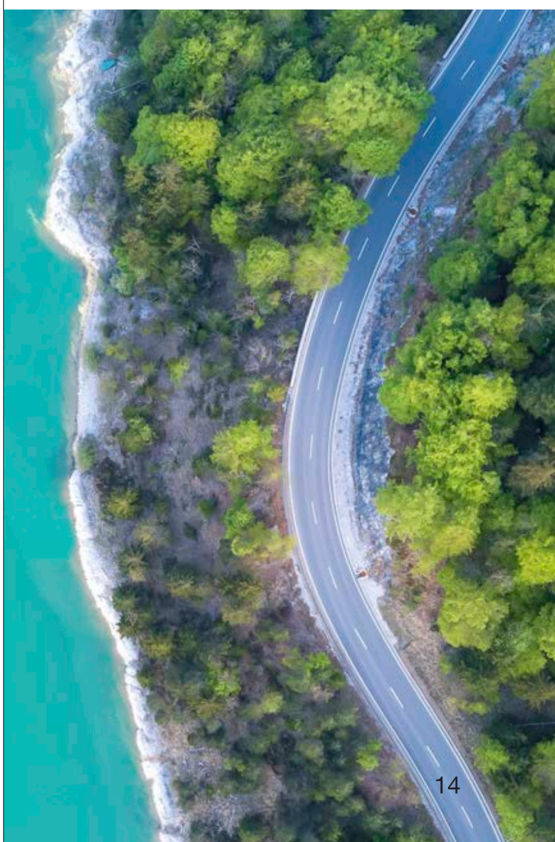
Currently, supply-chain ESG reporting is very much a mixed bag, I heard. There is certainly a class of B2B customers that want more-reliable ESG data, particularly along quantifiable domains like GHG emissions. Here, the pressure is for ESG reporting to move from subjective disclosure (such as Scope 3 estimates, which cannot be aggregated across value-chains) to countable, auditable metrics. That is, **there are powerful B2B customers that want certain domains of ESG to move from disclosure to *accounting***. The trouble remains that several of these customers are currently unable or unwilling to pay for their suppliers' performance along those ESG domains, as end-consumer preferences remain undercapitalised. This then creates a penalty for those who seek to be more accurate on ESG than their competition – for instance, why go through the effort to get a verified accounting number for your emissions performance when your competitor can win as much or more business by using industry-wide guesstimates for its Scope 3 disclosures?

I also heard of another class of B2B customers who are simply going through the motions on ESG. These customers take a check-the-box compliance approach to their suppliers' reporting, effectively outsourcing their ESG strategies to various standard-setting bodies such as Carbon Disclosure Project (CDP), Global Reporting Initiative (GRI), and Sustainability Accounting Standards Board (SASB). The customers themselves are likely responding to investor pressures to meet certain ESG "hygiene" thresholds, so that they can be included in various ESG-friendly indices. I heard especially from smaller companies that such compliance-based ESG reporting is an additional "tax" on doing business, since the standards are wide-ranging in scope and the proportional report-preparation costs are high. In effect, not being compliant with the various ESG standards can mean losing business, even as being compliant does not mean earning higher margins.

But defenders of this compliance approach, whom I also encountered, pointed out that even if the standards are blunt, they provoke reflection and (some) changes in real actions by reporting companies. So, they argue, the approach represents progress in meeting broader demands for ESG action in society.

In sum, I heard that consumers and customers want decision-useful ESG data, although whether supplying such data will eventually be profitable (a win-win) remains unclear.

What ESG data do investors want to see? Perhaps my greatest surprise-learning across the stakeholder meetings was in how little regard some preparers hold investors on ESG matters. Whereas, when it comes to financial performance, (institutional) investors can be expected to take a hawk-like approach – demanding deep, follow-up data and action when questions arise –



on ESG domains, I heard that these same investors often take a check-the-box compliance approach, deferring to off-the-shelf ESG standards.

Some of this situation can be attributed to the current state of the investor landscape, and I heard several explanations to that end. First, as already observed, active ESG-focussed asset managers are few and far between, and thereby unable to materially move stock prices over ESG (non)performance. Most price movements come from other active institutional investors who are largely focused on financial performance. Passive funds, who are nevertheless selling high-margin ESG products, are rarely querying beyond the ESG compliance checklists, reflecting perhaps an underinvestment on their part. And retail investors too rarely trade stocks on ESG data, as the ESG reports themselves remain costly to process due to their low reliability and low comparability.

Passive funds selling high-margin ESG products rarely query investees beyond ESG compliance checklists, reflecting perhaps an underinvestment on their part.

Some stakeholders I spoke with expressed cynicism over the entire ESG investing ecosystem, noting that some ESG buy-side funds are almost indistinguishable from sell-side intermediaries, in their lack of objectivity or critical analysis of corporate ESG performance. Moreover, some intermediaries, such as ESG ratings agencies, are seen as simply "selling credibility" to stock buyers who seem indifferent to having wool pulled over their eyes. Even not-for-profits in this space, such as Science Based Target initiative (SBTi), were not spared criticism. In effect, even as retail savers and pensioners have been convinced to invest in ESG funds, there appears to be little alignment along the investing supply-chain to ensure that these funds actually drive real ESG actions amongst companies. What makes such criticism especially biting is that it comes from some preparers themselves.

Many stakeholders expressed hope that the recently created ISSB, with its focus on ESG's financial materiality, will bring more rigour to ESG reporting at the corporate level, thereby improving ESG investing outcomes. But the concerns highlighted above go beyond the mandate of the ISSB (and of ESG reporting standard-setters), suggesting there is scope for capital-market regulators to play a more active role in policing what constitutes (and can be legitimately sold as) an ESG fund. Beyond regulation, proposals for a carbon-wealth tax on investment portfolios could drive a shift toward real accounting, at least in the "E" domain, and thereby real (decarbonisation) action. After all, investment funds are unlikely to want to be taxed on their portfolio companies' emissions guesstimates, which are themselves often double- or multiple-counted.

While all this does not mean that investors do not want to see ESG data, the overall impression I got was that **preparers currently feel more "heat" on ESG from B2B customers than from (institutional) investors**.

But, amongst those investors who did demand ESG data, the focus was on quantification, comparability, and auditing. As with the class of B2B customers who want more-reliable ESG data, these investors want ESG reporting to be more akin to accounting than disclosure. They lamented, with some irony, the current state of PDF-based ESG disclosures as both uncountable and unaccountable in this Big Data era.

Given that countable ESG data invariably means making choices to limit reporting to certain ESG domains (e.g., GHG emissions or water usage), I additionally queried these investors on whether aggregated "impact valuations" by companies offer a suitable alternative. Uptake for such valuations – which are efforts by preparers to create shadow prices for the ESG impact of their actions, thereby offering a fungible income metric, net of ESG – was tepid. Sophisticated ESG investors want hard, audited data, to which they can themselves apply impact-valuation methodologies; but they seemed sceptical of receiving such summary estimates directly from preparers.

The upside of moving toward more simple, comparable, and accurate ESG data along a few relevant domains is that such data can then be of use to retail investors as well, who are currently put off by the high cost of processing ESG reports. While there are likely differences in investment preferences between retail and institutional investors (e.g., on risk aversion), there is likely less variance across these investors on what data is useful for asset-allocation decisions. Supplying ESG data that is decision-useful to retail investors has the added benefit that it can create further demand for ESG reporting – in that useful supply creates its own demand – thereby also deepening the market forces that will police such reporting.

What ESG data do corporate managers want to see? While there is variable demand for ESG data amongst customers and investors, most preparers I heard from do believe that the ESG data they produce has an important real role in the economy and society. While this may sound self-serving on their part, their conclusions are often drawn from the usefulness of certain ESG data for their own decision-making. After all, managers manage what is measured, and some ESG measurements help corporate managers identify new wins, mitigate emerging risks, and create purposeful businesses.

Of course, amongst corporate managers, there are also notable disagreements on why they must engage in ESG actions and reporting thereof. For notational simplicity, we can organise managers into three groups:

01 Purpose warriors,

02 Profit-seekers, and

03 Practicalists.

The Purpose warriors see ESG as addressing externalities not captured through the pursuit of profit; the Profit-seekers see ESG as a strategy for creating and sustaining financial profits; and the Practicalists avoid embracing a "theory" of ESG, seeing it instead as simply meeting the (sometimes latent) demands of customers and investors.

There are some empirical regularities in the distribution of these three types of managers across geographies, industries, and company size: e.g., Profit-seekers are more common in the United States, Purpose warriors are more common in northern Europe, and Practicalists are more common in China

and India; also, Practicalists are more common in smaller companies. But, for the most part, all companies will likely have individuals of each ilk. In fact, the distribution of rank-and-file employees across these three groups itself creates an ESG challenge for corporate managers, as they must seek to placate all three constituencies to remain competitive employers.

Regardless of their disagreements on the reasons for ESG, most corporate managers agree that ESG reporting is not simply a tool for external communication – perhaps its more-important function is as a mechanism through which it motivates changes in behaviours within a company. Amongst the Profit-seekers, the ESG data item that most resonated was GHG emissions, as companies increasingly see value in (and risks from not) decarbonising their own operations and those of their supply-chain. The Purpose warriors agreed on this data dimension but argued that it should not crowd out other domains, like biodiversity, water use, and "S" factors such as avoiding modern slavery and child labour. Unsurprisingly, the Profit-seekers saw many of these added domains as boondoggles that could squander investors' capital.

Most corporate managers agree that ESG reporting is not simply a tool for external communication – its more-important function is to motivate behaviour changes within a company.

The Practicalists, particularly those in smaller companies, were more drawn to the "G" factors, noting that measuring and driving good corporate governance in businesses where this is lacking or nascent is a high value-add activity for their customers, investors, and society. Examples included having more truly independent directors, more due process in decision-making, and tighter financial and management controls. While pursuing these low-hanging "G" fruit are no-brainers, I suspect that they do not fully represent the kinds of activities that most people have in mind when they refer to ESG. The Practicalists were not as keen on emissions reporting as the Profit-seekers and Purpose warriors, citing the added costs and low-willingness of customers and investors to pay for those costs.

Another **source of ESG variation across managers was on the *nature* of ESG data – qualitative versus quantitative, soft versus hard, prospective versus verified, disclosure versus accounting**. Here, the divisions were most apparent based on corporate function: those in the finance or purchasing functions generally prefer fewer items *but* of countable and audited ESG data, while those in dedicated ESG-reporting roles, sitting outside of the CFO's umbrella, have greater taste for the current more-expansive state of qualitative and prospective ESG disclosures.

The quant-ESG camp pointed out that locating ESG-reporting apart from the CFO's office creates, in some cases, problems of greenwashing, as ESG targets are set too ambitiously (sometimes as a PR exercise) to meet activist demands, C-suiters do not take these targets seriously leading to their under-delivery across companies, and soft ESG data is then produced to cover-up the non-performance. They argued that if ESG actions are to be meaningful in meeting their purported aims, their reporting must follow similar practices as financial reporting.

The qual-ESG camp pushed back, arguing that such robustness can be counterproductive, reversing ESG wins. They noted the variable nature of customer and investor demand for ESG and the weak state of ESG regulation, arguing that under these conditions, more-rigorous ESG reporting would mean

less ESG action, as companies do not want to be caught explicitly overclaiming. They see the soft, prospective nature of ESG reporting as *inspiring* companies to action over the long run (rather than as holding companies accountable for delivered performance).

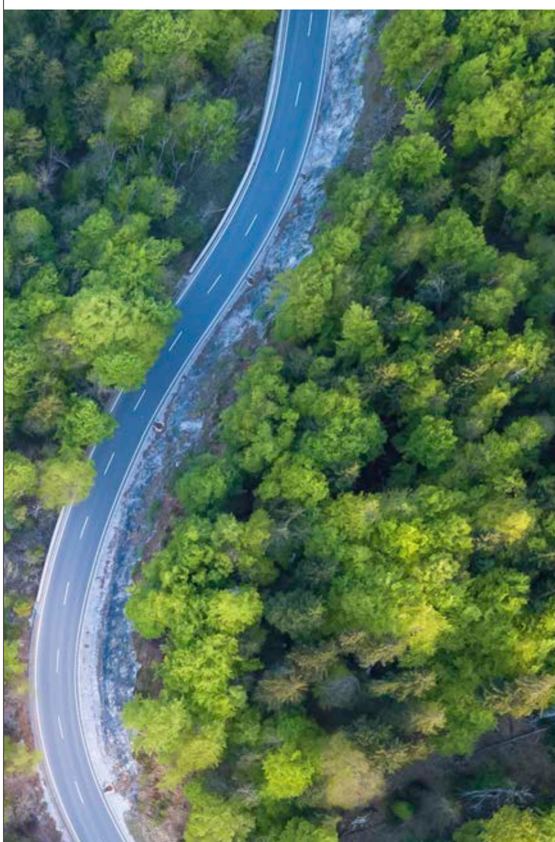
Finally, an area where most corporate managers agreed was on abandoning the term ESG. For all the "confusion" that it has come to assume, and for its increasing politicisation (especially in America), many in the preparer community felt that the acronym has run its course. A preferred alternative was the term "sustainability."

What ESG data is needed for the planet and society? Thus far, we have queried on commercial sources of demand for ESG reporting (from customers and investors) and on internal demand from managers themselves. But ESG, as the concept was originally conceived, referred to externalities not addressed by commercial demand channels. So, there is plausibly information on ESG actions demanded by non-commercial stakeholders that we have not already addressed. Whether companies should meet this demand depends on their worldview on the role of the corporation in society, and, as I stated earlier, I do not take a position on that matter in this paper. Nevertheless, for completeness, I did query various non-commercial activists on what they would like to see in ESG reporting, and I discuss some implications below.

I heard that the **demand for ESG actions on corporate externalities arises jointly from the emergence of major public-goods problems like climate change and from the failure of governments to adequately address these problems via regulation of corporate behaviour**. The latter is, paradoxically, due at least in part to some opportunistic corporate lobbying, but that is a matter outside the scope of this paper. In the face of unaddressed externalities, civil-society activists and, ironically, some governments have turned to corporations to embrace ESG actions and associated reporting.

When asked why demand signals from investors, customers, consumers, and insiders will not fully address the needs in society for ESG actions and reporting, activists offer a number of reasonable explanations. These include the problem of collective action (where even highly diversified investors like Vanguard do not have the incentives and wherewithal to drive companies to solve public-goods issues) and the associated problem of social discount rates, i.e., the time value of money for publicly beneficial projects (e.g., while the UK government's social discount rate is 3.5%, even large corporations use discount rates of 10% or higher, yielding very different cost-benefit calculations). Moreover, some of the externalities that are motivating calls for ESG actions are about addressing inequalities in distributional *outcomes*, which even well-functioning competitive markets cannot endogenously accomplish.

There is no shortage of market externalities in today's global economy. First, the world is struggling to sustainably address existential threats like climate change: even 2°C warming could fundamentally change life as we know it, but the cost of avoiding this outcome seems too large to bear for many governments. Add on the coming demographic shifts from rising incomes in parts of the world – for instance, by 2050, about half of all under-18s in the world will be

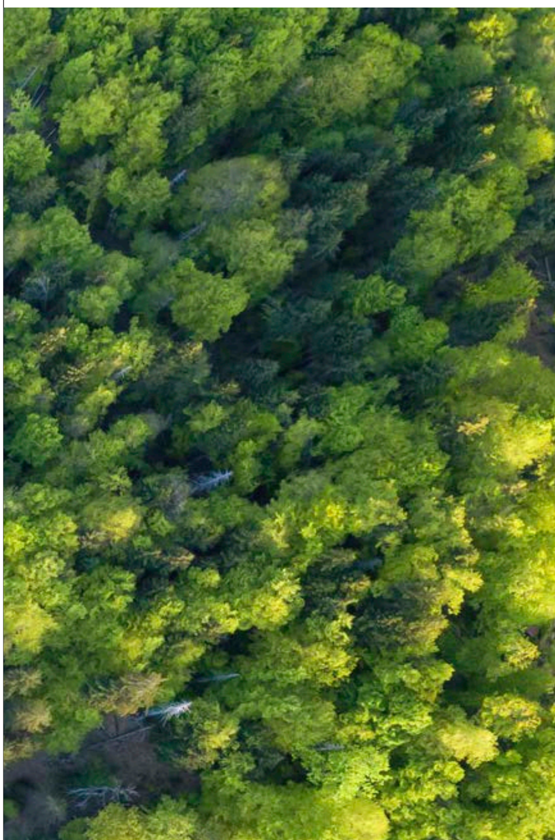


born in Africa – and there is a real concern that current systems of education, migration, and international trade are not fit for purpose. In fact, in many parts of the world, terms such as free trade and capitalism have come to assume a pejorative connotation, as people see these ideas as creating and exacerbating inequalities and destroying traditional values. I even encountered arguments in my meetings that ESG is a "pro-globalisation plot" amongst elites. And even as they fend off such criticisms, those elites are dealing with additional externalities such as trying to avoid conflicts created by rising geopolitical and economic tensions.

Doubtlessly, many of these externalities need top-down rather than bottom-up (corporate ESG) solutions. Nevertheless, in terms of specific domains for corporate ESG reporting, the claims from civil society are vast, and given free reign, each major NGO likely has its own unique data point for corporations to report on.

But, as a general rule, "urgency" and the degree of harm caused by direct corporate inaction are two driving determinants. Climate change is by far the most urgent of such global externalities, and here there is strong demand for corporate reporting on GHG emissions, even if participants differ on the form of such reporting (e.g., accounting versus disclosure), its accuracy, verifiability, etc. Beyond climate effects, water usage and maintaining biodiversity are especially worrisome issues in large parts of the globe, and many activists would be keen to see ESG reporting aimed at incentivising companies to be smarter on these fronts. Among the "S" issues, ending modern slavery and child labour in supply chains takes high priority especially in the West, although, notably, the governments of some countries where these practices are prevalent oppose such measures.

In the face of these non-market ESG demands, and all the other issues previously raised, preparers face a ripe challenge on what ESG data to measure and report. To address this challenge, the next section offers a pragmatic reporting framework for companies and potentially even standard setters.



CHAPTER III

Cutting through the "confusion": Pragmatic ESG reporting principles for companies

If there is one takeaway from the discussion thus far, it is that getting ESG right, both in terms of real actions and reporting thereof, is hard. In fact, part of the reason companies are facing the conundrums of what to do on ESG is that governments have effectively abrogated an active role in many of the ESG domains, relying instead on variable ESG-reporting regulations.

Governments have learned that there are no easy answers to making the trade-offs embedded across ESG actions. So, it is up to businesses to figure out how to be profitable while sustaining the legitimacy of those profits.

Perhaps this is partly because governments themselves have learned that there are no easy answers to making the trade-offs embedded across ESG actions. And so, it is up to businesses to figure out what to do – to determine how to be profitable while sustaining the legitimacy of those profits, both in the context of global competition and global varieties of capitalism.

Not all businesses will be motivated to respond to this challenge and not all will know how to do so; but those that ignore the problem risk obviation. So, what follows are some pragmatic steps for business to navigate the terrain. These steps can also inform the ecosystem of ESG standard-setting, which is itself searching for conceptual frameworks to cut through the ESG "confusion."

There are three common-sense observations that underlie the steps that follow. The first is that less is more; the second is that greater accuracy is preferable; and the third is that learning occurs over time.

By "less is more", I mean do not try to boil the ocean when it comes to ESG. While a corporation should certainly be aware (as a hygiene factor) of the breadth of its externalities, the landscape of ESG is so vast that a company attempting to cover all of it through its actions and reporting can result in it

accomplishing little or, worse still, getting into more trouble than by doing nothing. The latter can happen if stakeholders feel that the company, by spreading itself too thin, is avoiding materially tackling the most urgent and harmful externalities created by its operations.

Turning to the second observation: In focusing on accuracy over the status quo, I have picked a side in what I have previously described as an ongoing debate within the ESG community. But I think this is the sensible position for firms to take – as ESG issues gain more social prominence, the scope of scrutiny on corporate ESG claims will only increase, and it is in no corporation’s interest to be seen as wishy-washy, let alone unreliable. In the long run, no organisation (or indeed civilisation) in history has survived without holding itself accountable to the truth.

Finally, in stating that learning occurs over time, I wish to emphasise two points. First, that companies need not get it all right at once: especially given the uncharted and dynamic nature of ESG reporting at present, a company can experiment with what ESG domains on which to focus and how to hold itself accountable to its actions on those domains through its reporting. Second, that companies should thus remain in “listening” mode to feedback from stakeholders on their ESG actions and reporting. And, accordingly, they should be prepared to accept that feedback, admit mistakes, and correct courses of action where warranted.

All this, I will add, is rather self-evident and (should be) uncontroversial. But the fact that it bears expounding speaks to the chaos in ESG and to the opportunities in fixing it.

Step 1, Pick “three” ESG issues: Given the uncountable ways in which companies’ actions generate externalities, my first proposal is for a company to start with a countable set of ESG issues on which to focus. Elsewhere I have written that E, S, and G are each separate areas, each with countless domains, only brought together for notational convenience by a UN-backed report. Treating them as consubstantial, let alone fungible, is unworkable. So, here, I propose that companies begin with just three ESG-type issues – although certain larger companies may already be well underway with more issues, which is fine too, as long as they can then follow through with Step 2 below on high-quality measurement. If they cannot, then perhaps that is a signal to cut back on the scope of their ESG activities. For most smaller companies though, three issues are plenty to focus on as a first pass.

Treating E, S, and G as consubstantial, let alone fungible, is unworkable.

Picking three issues does not mean wholly abandoning other ESG domains – doing so would itself be imprudent, at least from a PR perspective. But it means keeping those domains in qualitative listening mode (see Step 3 below), while the priority areas become spaces for rigorous reporting and real actions. In effect, “three” issues can be a starting point for ESG reporting accuracy.

How to pick those three (or “n”) issues is, of course, a difficult matter, and one for the exercise of good judgement from the highest levels of the organisation – including the CEO, the CFO, other C-suiters, and the board. Importantly, this decision should not be relegated to the ESG reporting team alone, lest the tail try to wag the dog and inaction follows. Moreover, in many domains, ESG

actions can lower financial returns, and absent government regulation tilting toward ESG and away from economic growth, it is the firm’s top leadership and not its ESG reporting team (or ESG standard setters), who should be making the decisions on such economic trade-offs.

In making the decision, a number of factors can weigh in. First, if the company is in a B2B selling space with a small handful of key industrial customers, then it is those key customers who should chiefly determine the dimensions on which to focus. If the company has a diversified customer-base, or if the company is close enough to retail consumers to have a retail-brand identity, then it can engage in focused market-research testing the joint sensitivity of consumers to prices and prospective ESG performance on various domains, perhaps using tools such as rewired.earth to do so.

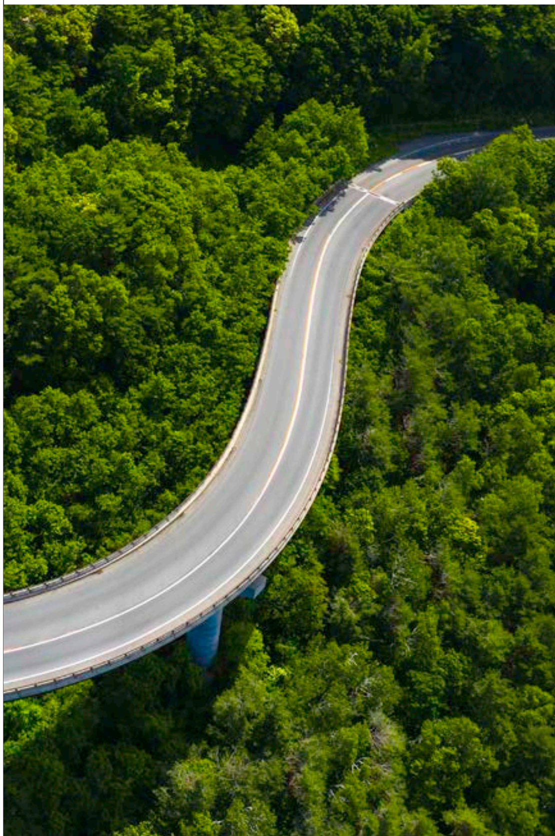
Second, the company should run these identified issue-areas by its investors, especially its active investors who drive price movements and its institutional investors who make long-term capital available. Do these customer-driven issues align with the priorities of investors? What other issues are investors likely to demand? Here, as we have seen earlier, certain investors are likely to defer to their favourite ESG standards, asking for a laundry list of compliance disclosures. Unless the company has the market power to push back on such investors, it will have to oblige, but not to the exclusion of the focus issue-areas now highlighted.

Third, likewise the company should run these issue areas of focus by its internal ESG stakeholders (e.g., both ESG-inspired and ESG-sceptical employees) as well as prominent external activists to get buy-in. A particularly useful question to have answered is: What domains are ESG proponents asking for instead of the three issue areas already identified? Conversely, what do the ESG sceptics identify as the costs of focusing on these issue-areas?

Fourth, as a final sense check, run the chosen issue-areas of focus across the whole matrix of the UN Sustainable Development Goals. These goals have come to be widely accepted globally, and they can give the organisation a further idea of what is missing from its initial issue-areas, what are ways in which ESG measurement around the chosen issue-areas can encompass more than one SDG (see Step 2), and what can be further issue priorities in the future (see Step 3).

> An advantage of starting with customers in ESG issue-identification is that it encourages companies to take a bottom-up, product-centric approach to ESG, rather than a top-down approach that is ideology- or activist-led.

Moreover, the product-centric approach makes it harder for companies to avoid acting on their asymmetric capabilities in addressing externalities – that is, to avoid focusing on “what really matters” by deflecting ESG reporting to peripheral issues. Put differently, **the approach helps companies home in on what is “material” from an ESG perspective, and the answers will likely differ across companies, sometimes even for those in the same industry. In fact, these differences can become the very basis of a companies’ ESG competitive edge.**



As a corollary to following customers, if a company has strong buyer-power in its supply chain, it can pass its ESG priorities up to its suppliers, and their suppliers and so on, creating cradle-to-gate consistency in ESG reporting domains. For instance, oligopsonistic retailers like Apple and Amazon have tremendous capability to shape product-specific ESG actions and reporting deep into supply chains.

At the end of this process, climate change is likely to be one of the dimensions of focus for many companies and product lines, given the global urgency of the matter and the sheer ubiquity of GHG emissions in any commercial activity today. And proposals such as the EU’s Carbon Border Adjustment Mechanism are only likely to shore up investors’ focus on climate accounting. Beyond climate change, different issue-areas such as biodiversity, water management, dignity of labour, diversity of workforce, etc., are likely to be differentially salient across different companies and products, highlighting the value of dynamic- and location-specific stakeholder research on such matters.

Step 2, Measure performance on dimensions that are simple, accurate, and comparable: Managers manage what is measured, but only if those measurements actually count. Bad data leads to bad decisions, and there is plenty of bad data currently in ESG reporting, in that the data is not understandable, reliable, and decision relevant. The processes in Step 1 are intended to home in on material ESG domains, and the processes in Step 2 are to address the data concerns. Here, foundational properties from financial accounting can inform what ESG reporting should look like.

If a company is serious about its three ESG focus-areas, then it should develop robust metrics around each of those areas. As previously discussed, **those metrics should be simple for intended users to understand, accurate in the sense of being both true and verifiable, and comparable across peers and reporting periods**. In effect, in Step 2, the company is committing to make its performance along its priority ESG issue-areas *count*, in a way that will likely feed back into which priority areas are then chosen.

The three measurement properties I have identified are fundamental to accounting practice, but not well-developed in the context of ESG domains where uncountable disclosure is common. So, a transition from disclosure to accounting practice on ESG will not be without some (internal) resistance, as was highlighted in the previous sections reporting on my stakeholder meetings.

Turning ESG issue-areas into metrics is not trivial, which is one reason to limit the focus on three to begin with. The operating principle here is that it is better to do a few (important) things right than to do many things incorrectly. If the company cannot measure what it is trying to do with its ESG actions – at least in the sense of intermediate outputs, if not eventual outcomes – then, chances are that it is not doing anything worthwhile.

For some domains like climate change, there are metrics like GHG emissions that immediately stand out as potentially meeting the three criteria. For other domains such as diversity of employment created, finding a sensible metric will be harder, but that is not an excuse to avoid doing so. Moreover, even with metrics like GHG emissions, companies will need to embrace standards

Bad data leads to bad decisions, and there is plenty of bad data currently in ESG reporting, in that the data is not understandable, reliable, and decision relevant.

that ensure that what is reported is accurate and comparable. For instance, while the GHG Protocol’s Scope 1 metric of *direct* enterprise-emissions meets all three measurement criteria, its Scope 3 metric of *value-chain* emissions is neither accurate nor comparable, per the Protocol’s own admission. This invites companies (and standard setters) to embrace new methodologies to ensure sound ESG accounting.

Indeed, there are implications here for ESG standard setters. Across our stakeholder meetings, participants noted with some alarm the proliferation of ESG standards across multiple domains, especially in Europe, even as the mood over ESG shifts in America and attitudes remain tepid in emerging economies. Several participants saw ESG standard setters as trying to do too much. The less-is-more and accuracy principles that I have advanced here can be useful guides for standard setters as well, beyond companies.

To choose a metric for a given issue-area, the company can ask the following pragmatic questions:

i. Is the metric intuitively understandable in its units of account?

ii. Can the metric be assured in a “true and fair” sense?

iii. Can data tools such as distributed ledgers and blockchains make reporting under this metric more accurate and lower cost?

iv. What support is provided by existing standards to report under this metric?

v. Is the metric used by peers, suppliers, customers, investors, and activists?

vi. Does the performance along this metric meet the spirit of one or more of the SDGs?

The focus on countable metrics in the respective domains of impact means that companies cannot hope to summarise their ESG actions into a single statement of value. Doing so is ontologically impossible, as it involves treating morally non-fungible actions as fungible. Moreover, as Robert Kaplan has observed, running a business is complex and requires weighing many metrics at once – just as one would not want a pilot to consolidate all cockpit instruments (airspeed, altitude, temperature, thrust, etc.) into a single summary statistic, one should not want a CEO to do the same with ESG domains (let alone try to consolidate ESG into profits).

Step 3, Iterate with users to develop and (possibly) expand robust ESG accounting to other domains: A key feature of ESG accounting today, as it compares with both financial *accounting* and ESG *disclosure*, is that it is largely unregulated. While this situation may not be ideal from the perspective of public policy, what it means for companies is that they have the ability to innovate and

experiment on ESG accounting domains, metrics, frequency, and formats to find what works. To be credible, this learning process should happen transparently, in good faith, and in active conversation with identified users of ESG reports (be they customers, investors, activists, employees, or even ESG standard setters).

Critics of the quantification approach to ESG reporting that I have advocated in Step 2 point out that ESG actions are, by their nature, intersectional and complex, not lending themselves to robust, discrete identification via metrics. They argue for a more narrative approach to ESG reporting. Indeed, there is some merit to this claim, and here in Step 3, I propose that companies engage in a qualitative conversation with users on their ESG accounting metrics and how they connect with the given organisation’s broader theory of ESG value creation.

That is, starting from the three ESG issue-areas and respective metrics identified in Steps 1 and 2, companies can develop “case studies” that tell *specific*, *verifiable* stories of how performance along those ESG dimensions is having impact (or not). These case studies have two strengths: First, they help validate the metrics and determine if they are indeed making a difference. Second, the stories can reveal unintended consequences or other possible domains for action that can be embraced if the company wishes to grow its ESG footprint or to change its ESG focus away from the three areas initially chosen.

Put differently, **Step 3 is an opportunity for a company to improve its ESG metrics, to explore its ESG impact in the intersectional and uncountable domains, and to determine what parts of its ESG reporting should be in the space of what the US SEC calls S-X reporting** (objectively verified, reasonable assurance, per Step 2) versus S-K reporting (more prospective disclosure with limited assurance, via case studies).

One caution to this more rigorous approach to ESG is that the truth will not always be rosy, and some stakeholders (including employees) may abandon a company when times are rough. This is especially the case if its competitors continue to peddle fluff in ESG reports and stakeholders buy into that.

But there is a natural learning cycle to the three steps run iteratively. For instance, at first, a business’ objective in choosing the three ESG issues-areas (per Step 1) may well be to “do no harm” along those dimensions. Then, as it gets better at measuring its performance on the dimensions (via accurate and peer-comparable metrics per Step 2), the chosen ESG domains can become the basis for competitive differentiation. Finally, as superior performance in those domains becomes commoditised – effectively, a hygiene factor of doing business in that space – the company can move on to other ESG domains for further competitive distinctiveness.

For instance, a company that accurately measures its controllable cradle-to-gate performance on GHG emissions can, over time, identify innovations in its purchasing and production methods that reduce those emissions, winning new business from carbon-conscious customers and eventually re-setting standards for what are acceptable emissions in its industry. This is a realistic, sustainable, and pro-market approach to combating climate change.

Of course, as I heard from preparers large and small, most businesses will need much guidance on all three steps. While large businesses can afford to self-fund given the scale economies involved, many smaller businesses will need grants or subsidies to kick-start the learning process. If investors and large B2B customers are serious about ESG performance, they are well-served to provide such incentives to smaller companies, keeping the focus on a few, quantified ESG metrics with supporting verified case-studies.

> I close this section by noting that nothing in what precedes is inconsistent with ESG standard setting, particularly that from emerging prominent players such as the ISSB. That said, the ISSB has, for instance, made certain early design decisions to focus on ESG disclosure, not accounting, and on financial materiality for ESG reporting, rather than taking a broader view.

The three-step approach developed here suggests that those design choices can be too limiting, even as it offers ideas for standard-setters to streamline their work and enable more rigour in the ESG reporting space. Indeed, if the newly created ISSB were to simply deliver on rigorous carbon accounting in its first five years, it would do an invaluable service to humanity even while building its reputation to subsequently take on further ESG domains. Pragmatically, I suspect that this would be the strategy with the least (stakeholder) opposition globally and most mission impact.

CONCLUSION

ESG is, as a term, constantly evolving, meaning different things to different people, evoking different value-judgements. But at its core, ESG refers to a set of actions expected of for-profit corporations to address real challenges in society, whether those actions are profitable or not.

Companies cannot ignore ESG demands, even as they cannot ignore the tremendous variance in those demands. The stakeholders I interviewed for this project are but a microcosm of the tremendous diversity of perspectives on ESG expectations of corporations, and, unsurprisingly, they disagreed on much.

To make sense of this confusion, this paper presents a pragmatic case for preparers to supply focused and accurate data on the planet and society that can be used by investors, customers, and their own employees in resource-allocation decisions. The case presented here is also iterative in that such supply will improve over time, generating further demand, and potentially revealing new business opportunities and sustainably addressing some of the social angst that is at the heart of activists' demands for ESG.

The results of this project, I hope, will be a source of advantage for companies looking to be more effective in the ESG space. I also hope the report will inform the tremendous, often cross-current, momentum in the ESG standard-setting community.

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Karthik Ramanna is Professor of Business & Public Policy at the University of Oxford's Blavatnik School of Government and a fellow at St. John's College. An expert on business-government relations, sustainable capitalism, and corporate reporting & auditing, Professor Ramanna studies how organisations and leaders build trust with stakeholders. His scholarship has won numerous awards, including the Journal of Accounting & Economics Best Paper Prize, the Harvard Business Review-McKinsey Prize, and three times the international Case Centre's prizes for "outstanding case-writing," dubbed by the Financial Times as "the business school Oscars." At Oxford, Professor Ramanna is founder and faculty chair of the Transformational Leadership Fellowship, a bespoke, by-invitation program for senior leaders looking to reimagine their public-service impact. In 2022, he co-founded the E-liability Institute with a mission to accelerate decarbonisation innovations through rigorous GHG accounting. Previously, Professor Ramanna taught at the Harvard Business School. He has a doctorate from MIT's Sloan School of Management.

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