Bridging the Disclosure Gap: Investor Perspectives on Environmental, Social, & Governance (ESG) Disclosures

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Bridging the Disclosure Gap: Investor Perspectives on Environmental, Social, & Governance (ESG) Disclosures

Abstract
The corporate sector and the investment community are key players towards achieving sustainable development. By measuring and disclosing the economic as well as social and environmental impacts, companies can work towards this goal. Investors on the other hand are increasingly looking to integrate ESG metrics into their investment analyses for improved decision making, enabling them to minimize risks and maximize returns over the long-term. Sustainability reporting, as an enabler, is an essential tool that can guide the corporate sector to meet investor expectations on ESG metrics. However, there continues to be a disparity between what is being reported and what investors consider material while making investment decisions. The aim of this research was to throw light on the prominent ESG metrics and reporting frameworks investors are looking at while managing their investment portfolio and the current difficulties that needs to be addressed to achieve full ESG integration. The study was based on a macroeconomic perspective looking at how corporations generally report their sustainability practices globally and the metrics investors use in their decision-making strategies. The Global Reporting Initiative (GRI) standards remains the most popular framework for sustainability reporting worldwide and the annual report is held in highest regard for non-financial disclosures by most of the investors. Results show that while the types of ESG metrics sought by investors differs across sectors, Governance, which includes board accountability, executive compensation, human capital management and board diversity seems to be the overriding issue across all industries. Environmental and Social risks are equally critical to financial performance and investors will demand for greater disclosure as more data becomes available. Clarity on investor goals matched with a framework of ESG metrics that meet a high standard of methodological rigor would enable systematic analysis of company performance. It is only a matter of time before full ESG integration becomes mainstream, and by bridging the disclosure gap, both the corporate sector and the investment community can work together towards sustainable development.

Disciplines
Environmental Sciences | Physical Sciences and Mathematics

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Spring 2018

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ABSTRACT

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I would like to express my sincere gratitude to my primary and secondary readers Paul Herman and Dr. James R. Hagan for providing their invaluable guidance, comments, and suggestions throughout the course of this research. I would like to specially thank my primary reader Paul Herman for accepting to help me with this project despite his busy schedule as the CEO of an investment management company. I would also like to extend my gratitude to my secondary reader and program advisor Dr. James R. Hagan for the constant support throughout my graduate study and helping me in completing this research project. Last but not least, I would like to thank my program director, Dr. Yvette Bordeaux and the Department of Earth and Environmental Sciences at the University of Pennsylvania for providing me with the guidance and resources required to complete this capstone project.
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1. **Introduction:**

According to the World Council for Economic Development (WECD), sustainable development is “development that meets the needs of the present without compromising the ability of future generations to meet their own needs”. The corporate sector and the investment community are key players towards achieving this goal. By measuring and disclosing the economic as well as social and environmental impacts, companies can work towards sustainable development. Sustainability reporting, as an enabler, is an essential tool that can advance the private sector contribution to global sustainable development.

85% of the S&P 500 companies published Corporate Sustainability Reports in 2017 and this indicates the movement towards greater transparency and accountability¹.

Investors on the other hand are increasingly looking to integrate Environmental, Social and Governance (ESG) metrics into their management portfolio for improved decision making, enabling them to minimize risks and maximize returns over the long-term. These investors include institutional pension funds, sell-side analysts, hedge funds, endowment foundations, banks, insurance firms, credit rating agencies and retail investors. Recent years have seen a surge of investor interest in integrating ESG information into financial analysis and investment decision-making. Signs of this trend include continued growth in the volume of managed assets that incorporate ESG research. According to data collected by the Global Sustainable Investment Alliance, ESG investment strategies, broadly defined, currently account for $22.9 trillion in managed assets worldwide, up from $13.3 trillion in 2012². Increase in ESG information providers, ESG information gathering

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¹ G&A Institute, *FLASH REPORT: 85% of S&P 500 Index® Companies Publish Sustainability Reports in 2017* (USA: Governance and Accountability Institute,[2018]).
² Vezér Martin et al., *How Investors Integrate ESG: A Typology of Approaches* (United States: Sustainalytics,[2017]).
frameworks, indices incorporating ESG data, and the use of ESG factors across asset classes have all contributed to this cause.

Corporations and ESG research providers are coming up with innovative methods to disclose non-financial information in a manner that is material and transparent to stakeholders. However, there continues to be a disparity between what is being reported and what investors consider material while making investment decisions. The aim of this study is to throw light on the prominent ESG metrics and reporting frameworks investors are looking at while managing their investment portfolio and the current difficulties that needs to be addressed to achieve full ESG integration.

2. **Importance of ESG Integration:**

ESG analysis provides investors with an additional lens for reviewing and evaluating companies and assets, not just for equity performance, but also for factors that affect bond pricing and real asset valuations\(^3\). Traditional investors initially had a perception that ESG integration meant sacrificing financial returns and hence a violation of fiduciary duty\(^4\). However, the business case for ESG investing is evident and approximately 90% of empirical studies find a non-negative relation between ESG and corporate financial performance. At the securities level, studies show that companies which better integrate ESG metrics have a lower cost of capital and outperform their peers in both market-based and accounting-based financial performance\(^5\). A CFA institute survey revealed that the

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\(^{3}\) Institutional Investors Research Lab, *Is Your Nonfinancial Performance Revealing the True Value of Your Business to Investors?* (USA: Ernst & Young, [2017]).

\(^{4}\) G. Robert Eccles and Mirtha D. Kastrapeli, *The Investing Enlightenment: How Principle and Pragmatism can Create Sustainable Value through ESG* (USA: State Street, [2017]).

main reason investors take ESG issues into consideration in their investment analysis are to help manage investment risks and 51% of those considering ESG issues systematically integrate them into the whole investment analysis and decision-making process\textsuperscript{6}.

The way that investors use ESG information is also evolving. Investors previously favored an approach that strictly separated the ESG and financial aspects of portfolio management, and with separate teams of analysts. But now, more investors are integrating ESG factors into their normal investment analysis. This growing interest in ESG integration also reveals that investors understand that financial metrics tell only part of a company’s value story. 62.4% of investors are concerned about the risk of stranded assets. They are the clearest pieces of evidence revealing that risks stemming from environmental and social factors can impact investor perceptions of business performance\textsuperscript{7}. Intangibles and externalities are equally important when investors evaluate a company’s strategy, risk profile, and ultimately, its plan for creating long-term value. Investors also understand that ESG integration is diverse and differs across countries, industries, and even firm strategies\textsuperscript{8}.

Figure 1 shows the gradual increase in the market value of intangible assets over the years. ESG factors have a direct correlation with intangible assets and can significantly impair a company’s performance if not managed properly. Human capital, Social capital, and Natural capital could affect these intangible assets and therefore investors want to invest in businesses that generate value across these capitals apart from financial returns as they believe that it is integral to the long-term success of a company.

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\textsuperscript{6} CFA Institute, \textit{Environmental, Social and Governance (ESG) Survey} (USA: CFA Institute,[2017]).
\textsuperscript{7} Institutional Investor Research, \textit{Tomorrow’s Investment Rules 2.0} (USA: Ernst and Young,[2015]).
Therefore, it is essential that companies disclose the most material ESG factors affecting their business to investors and other stakeholders.

3. **Growth of Sustainability Reporting:**

Public pressure and the need for greater transparency has caused corporations to disclose non-financial information apart from financial performance metrics for their annual reporting requirements. Regulation, stock exchanges and investor pressure also continue to play a key role in driving up sustainability reporting rates around the world. The risk of reputational damage already has convinced some non-reporters to start reporting with more expected to follow suit. 78% of the world’s top 250 companies disclose sustainability
performance in their annual financial reports as they believe that this data is relevant for their investors\(^9\).

As sustainability reporting has increased throughout the years, global standards, and guidelines for disclosing this information have been developed as well by various organizations. The Global Reporting Initiative (GRI) standards remains the most popular framework for sustainability reporting worldwide. GRI provides a framework to guide the sustainability reporting process and performance metrics by taking a multi-stakeholder approach and enabling full disclosure of an organization’s environmental and social impacts. The Carbon Disclosure Project (CDP) is another global framework which runs the global disclosure system that enables companies, cities, states, and regions to measure and manage their environmental impacts\(^10\). The CDP also has a broad stakeholder approach and focuses in providing data on climate change, water, and forests.

The International Integrated Reporting Council (IIRC) is a novel framework that targets providers of financial capital. The goal of IIRC is to enable organizations to move towards integrated reporting by disclosing financial and non-financial information in a combined annual integrated report, thereby preventing the need for a standalone sustainability report.

The Sustainability Accounting Standards Board (SASB) is another reporting framework that primarily targets investors in the US public markets. It follows a sector-based approach by identifying material issues across different industries in the US and reporting those metrics so that investors can make informed investment decisions.

Table 1 gives a brief explanation of the prominent reporting frameworks and its relevance to different stakeholders.

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\(^9\) KPMG, *Currents of Change: The KPMG Survey of Corporate Responsibility Reporting* (USA: KPMG,[2015]).

\(^10\) Deloitte, *Sustainability Disclosure, Getting Ahead of the Curve* (USA: Deloitte,[2016]).
Recently, the Financial Stability Board’s Task Force on Climate Related Financial Disclosures (TCFD), released a framework to help identify the information needed by investors, lenders, and insurance underwriters to appropriately assess and price material climate-related risks and opportunities. The mission of the TCFD is to encourage companies to integrate climate change risks and opportunities into financial analysis and disclose them in their annual financial filings. Although ambitious, this could be seen as a key step towards monetizing and quantifying non-financial information, thereby providing investors with the data to appropriately assess and price climate-related risks and opportunities.

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11 TCFD, Recommendations of the Task Force on Climate-Related Financial Disclosures (USA: TCFD, [2017]).
However, all these disclosure frameworks are voluntary and are not legally binding or mandatory. There are also numerous challenges associated with reporting sustainability performance. For large organizations preparing to disclose ESG performance metrics, data collection and ensuring the accuracy of data collected requires tremendous effort in terms of resources and commitment. It also becomes a challenge to satisfy all the stakeholders who have different motives and expectations from the organization. But once companies understand the value proposition behind reporting ESG metrics and the opportunity to drive performance improvements internally and externally, regulation between voluntary or mandating sustainability reporting will not be an issue of concern.

4. **Role of ESG Reporting & Ratings in influencing Investor decisions:**

Investors are increasingly looking to find a standalone framework which will allow them to identify and compare material ESG issues in a consistent and transparent manner. Several reporting frameworks discussed above such as the GRI, SASB, IIRC are establishing their own standards companies should follow depending on stakeholder needs, to report on the materially relevant issues impacting their businesses. However, it is important to consider what investors are looking at for finding material information that will assist them in their investment decisions.

An Ernst and Young report revealed that investors read widely in search of valuable non-financial information and no single source dominates decision-making\(^{12}\). Surveyed investors reported that the most useful source of nonfinancial information for making investment decisions was a company’s own annual report deemed “essential” by 31% of

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survey respondents and “very useful” by 32%. The second-most-useful source was an integrated report deemed “essential” by 18% and “very useful” by 39%. While the annual report is held in highest regard for non-financial disclosures by most of the investors in the survey, 60% believe that companies don’t disclose ESG risks that could affect their business and that they should disclose them more transparently. One of the strategies recommended was to make the report more connected and integrated as this will seek to avoid the risk of producing disparate reporting that does not align or create contradicting disclosures.

| How useful do you find the following sources of nonfinancial information when making an investment decision? |
|-------------------------------------------------|-------------------------------------------------|----------------|----------------|----------------|
| Annual report                                   | Integrated report                               | Press coverage and business commentary         | Corporate web site (including sustainability and corporate governance) | ESG information from a financial data provider |
| 31%                                             | 18%                                             | 15%                                           | 15%                                         | 11%                                         |
| 32%                                             | 39%                                             | 41%                                           | 40%                                         | 43%                                         |
| 30%                                             | 34%                                             | 36%                                           | 34%                                         | 32%                                         |
| 7%                                              | 9%                                              | 8%                                            | 11%                                         | 14%                                         |
| Annual report                                   | Integrated report                               | Press coverage and business commentary         | Corporate web site (including sustainability and corporate governance) | ESG information from a financial data provider |
| 31%                                             | 18%                                             | 15%                                           | 15%                                         | 11%                                         |
| 32%                                             | 39%                                             | 41%                                           | 40%                                         | 43%                                         |
| 30%                                             | 34%                                             | 36%                                           | 34%                                         | 32%                                         |
| 7%                                              | 9%                                              | 8%                                            | 11%                                         | 14%                                         |

Figure 2: Source: Ernst & Young, “Is your nonfinancial performance revealing the true value of your business to investors?”, 2017

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With the recent release of the TCFD, more investors now want companies to perform 2° Scenario Analyses to adequately disclose risks associated with a 2° economy. Ultimately, reporters need to understand that investors are seeking to minimize risks from their investment portfolio and therefore view reports as a resource that enables them to get a transparent picture of the company’s overall performance.

Apart from reports, investors are increasingly relying on ESG ratings providers to assess and measure non-financial company performance over time and as compared to peers. Not only are the ESG raters potentially influencing the returns on an ever-expanding pool of retirement savings, university endowments and other investments, but they are also affecting company’s strategic decisions. According to the Global Initiative for Sustainability Ratings (GISR), over 100 organizations produce sustainability research and ratings on companies and the collective influence of these raters is only set to grow in the future as ESG integration becomes mainstream. Some of the leading ESG research companies include Bloomberg, MSCI, Sustainalytics, CDP, RepRisk and Trucost. Some organizations such as HIP Investor provide specialist services incorporating ESG metrics that generates optimal risk-adjusted returns while having a net positive impact on society.

It is a fast evolving and an extremely competitive market. Many have formed strategic partnerships with other ESG rating firms to provide greater cooperation, such as Morningstar collaborating with Sustainalytics and CDP establishing data partnership with

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RepRisk. However, the consensus view is that the sector will eventually consolidate with only few a ESG research and ratings providers dominating the market\(^{17}\).

From an investor perspective, despite greater availability of ESG data, there remains an incomplete understanding of how companies are performing along different dimensions of sustainability. This is because different firms have different rating methodologies which investors believe could lead to a compromise in the quality of data provided. But the future risks of not incorporating ESG data into investment analysis are far too greater for investors to ignore. Therefore, investors should be aware of the strengths and limitations of the organizations providing ESG research and ratings before incorporating them into their investment analyses.

5. **Investor Styles for ESG Investing:**

Different investors have different motivations for applying ESG metrics into their investment decision making processes and hence use a variety of investment strategies. Exclusionary or Negative screening is a type of investment strategy that avoids investing in securities based on investor moral values or to reduce risk. This strategy primarily avoids investment in sin industries such as gambling, alcohol, tobacco, and firearms. It is the oldest and the most widely used ESG investing strategy. Inclusionary or Positive screening is the practice of investing in companies that actively choose to pursue sustainable business practices. Investors utilize a wide variety of E, S, and G factors that they consider material to financial performance based on their personal criteria\(^{18}\).

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Best-in Class investing strategy involves investing in companies that have the highest rated or improving ESG performance relative to their sector peers. This could also include investing in best-in class oil and gas companies thereby providing investors with a well-rounded portfolio but still pursue sustainable investing. Thematic or Factor based investing focuses on specific sustainability themes such as sustainable agriculture, clean technology, social benefits, and environmental services. These strategies are meant to enhance an already diversified portfolio and hence are too risky to function as stand-alone investments. Full ESG integration involves investing with a systematic and explicit inclusion of ESG risks and opportunities. The goal of this strategy is to generate superior risk-adjusted returns and minimize long term risks that could impact businesses.

Active Ownership is an engagement approach where investors take advantage of their rights as shareholders and enter dialogue with companies on ESG issues that they consider financially material, thus influencing the behavior of a company through proxy votes and shareholder resolutions. Therefore, it is essential to understand that investors have differing preferences when it comes to sustainable investing although the primary motivation is to seek long-term positive returns.

6. **ESG Factors Investors consider Material:**

A key importance of ESG integration for investors is risk avoidance and transparent measurement of their investment portfolio. Investors believe the biggest factors motivating companies to report ESG information are the reputation of companies with their customers and regulatory compliance mandates. While the biggest motivating factor for investors to

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19 Morningstar, *What’s in a Name? the Many Dimensions of Sustainable Investing* (USA: Morningstar,[2016]).
integrate ESG metrics is because they consider it financially material to investment performance. Poor Corporate Governance, Environmental and Human Rights risk were most likely to alter investment decisions\textsuperscript{21}. The CFA institute survey also found out that Board accountability, Human Capital and Environmental Degradation were the most sought-after metrics in the investment analysis (described in Figure 3). The next important categories within ESG, investors consider relevant to financial performance included Demographic trends, Resource scarcity, Executive compensation, Climate Change, Supply Chain and Board diversity\textsuperscript{22}.

![Figure 3: ESG metrics investors consider. Source: CFA Institute, “Environmental, Social and Governance Survey”, 2017](image)

Understanding how the materiality of ESG information varies across countries, industries and firm strategies is of primary importance. Two research reports by the GRI and RobecoSAM Investing analyzed the most material issues investors consider across sectors. Within the Technology, Hardware and Equipment sector, the most important issues were Innovation Management, Supply Chain Management, Corporate Governance, Human

\textsuperscript{21} Institutional Investors Research Lab, \textit{Is Your Nonfinancial Performance Revealing the True Value of Your Business to Investors?} (USA: Ernst & Young, 2017).

\textsuperscript{22} CFA Institute, \textit{Environmental, Social and Governance (Esg) Survey} (USA: CFA Institute, 2017).
Capital Management, Environmental Enabling, Privacy Protection, and Data Security. For the Financial sector, Risk Management, Corporate Governance, Human Capital Management, Business Ethics, Financial Inclusion, and Emerging Markets Growth were the most important issues\(^\text{23}\). From an investor perspective for the mining sector, issues with the greatest financial materiality were Environmental Management (including Climate Strategy), Management of Local Stakeholders, Occupational Health and Safety and Labor Relations. For the Metals sector, issues with the greatest financial materiality were Climate Strategy, Operational Eco-efficiency, Occupational Health and Safety, and Social Impact on Communities. For the Electric Utilities sector, Climate Strategy, Regulatory Affairs Management, Operational Excellence, and Innovation Culture were the most material issues investors consider\(^\text{24}\).

![Figure 4: Leading ESG criteria for Public funds. Source: US SIF Foundation, 2016](image)


\(^{24}\) Alyson Slayter et al., Defining what Matters: Do Companies and Investors Agree on what is Material in the Mining, Metals and Electric Utilities Sector? (USA: GRI,[2016]).
ESG factor consideration also varies across different investors. Leading ESG considerations by money managers include, board issues, climate change, pollution/toxics, human rights, and conflict risk. Leading ESG considerations by institutional investors include human rights, climate considerations, political lobbying, and military weapons. Public funds (Figure 4) consider conflict risk, tobacco, board issues, human rights, and climate change as some of the leading ESG issues as part of their investment portfolio²⁵. These results show that Governance metrics are considered relatively more material by investors followed by Social and Environmental metrics but also reveals that they understand the financial implications of these metrics and are proactively looking to integrate them into their portfolio analyses.

7. **Challenges to achieving Full ESG Integration:**

ESG reporting has become mainstream for companies and investors are expecting transparent disclosure of information. However, there isn’t complete alignment between investors and companies on what, where, and how often to report. A PwC report states that corporates and investors see different value in disclosing data. The primary reason being, that corporates focus on growth while investors focus on risk²⁶. Investors and corporates also speak different languages when it comes to ESG issues, a challenge exacerbated by competing frameworks and standards that are designed for different audiences.

ESG disclosures are voluntary which gives companies the flexibility to choose among different frameworks for reporting, thereby resulting in information that is not necessarily comparable from company to company. More than nine out of ten investors (92%) say

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²⁶ PwC, *Investors, Corporates, and ESG: Bridging the Gap* (United States: Pricewaterhouse Coopers,[2016]).
companies are not disclosing ESG data in a way that makes it easy to compare to other companies, while 60% of corporates say the data they disclosed is comparable to that of other companies. Investors believe that ESG reporting should be relevant to operational and financial performance and the ways companies manage it to achieve long-term financial sustainability should offset long-term risks. But until we get to a common framework and set of standards, inconsistent disclosure will undoubtedly affect the usefulness of ESG data.

Divergent investor interests and expectations makes it difficult for reporters to disclose ESG information. No two investors would highlight the same ESG metrics and range widely in how much they prioritize optimizing their returns versus having their portfolios aligned with their values. We have seen that investors apply different sustainable investing strategies (Exclusionary, Positive, Thematic, Best-in class, Full ESG Integration) and this spectrum of investors generates highly divergent views as to what the appropriate list of sustainability issues would be and thus what ESG metrics are relevant on an individual level.

Available data does not currently allow forward projections of value and investors tend to assess companies based on backward looking ESG performance. However, if analysts had access to a framework of ESG metrics that offered a forward-looking gauge of sustainability parameters related to growth, productivity, and risk, then these indicators might help investors clearly differentiate between sustainability leaders and laggards. This

27 PwC, Investors, Corporates, and ESG: Bridging the Gap (United States: Pricewaterhouse Coopers,[2016]).
28 Daniel C. Esty and Todd Cort, Corporate Sustainability Metrics: What Investors Need and Don’t Get (USA: ,[2016]).
will in turn enable them to invest in those companies whose returns will outperform the market.

Another critical challenge faced by investors is the availability of quantifiable ESG data to check cross-company comparability. Overall, investors globally agree that the main factors that impede integration of ESG data in the investment process is the reliability of data and believe that ESG disclosures are still a very qualitative approach.\(^\text{29}\)

Quality of assurance with self-reported sustainability data and metrics is another point of divergence across companies. Although organizations that disclose sustainability metrics verify their reports through third party audits, most of the verification only covers a small portion of the information in the reports. Therefore, when analysts collect data, it is not very transparent which metrics and which data points have been verified, if any at all.\(^\text{30}\)


The challenge of developing a sustainability metrics framework that meets investor needs is complicated by the wide range of issues as discussed above. However, there has been a positive trend towards incorporating ESG metrics in investment decision making as investors begin to realize its benefits and shift from short-term horizons to managing risks for the long-term.

8. Conclusion:

The growing focus of investor interest on ESG issues has increased the importance of disclosing material risks for companies in all industries and companies that embrace this reality will be able to manage ESG risks as a core component of their overall business and innovation strategy. While the types of ESG metrics sought by investors differs across sectors, Governance which includes board accountability, executive compensation, human capital management and board diversity seems to be the overriding issue across all industries. Environmental and Social risks are equally critical to financial performance and investors will demand for greater disclosure as more data becomes available.

Clarity on investor goals matched with a framework of ESG metrics that meet a high standard of methodological rigor would enable systematic analysis of company performance. The first step involves having the right standards that enable reporting on material ESG risks to investors and providing comparability among companies. Integrated reporting will play a pivotal role in addressing this concern as investor preferences becomes increasingly aligned with this framework. Investor engagement is a critical tool that companies should leverage for communicating ESG performance. The adage, “What gets measured, gets managed” should be applied by companies in quantifying their ESG metrics
so that investors can better associate it to financial performance. The signatories for the United Nations Principles for Responsible Investment (PRI) has grown from 63 in 2006 to 1,714 today, with Assets Under Management (AUM) having increased from US$6.5 trillion to US$ 68.4 trillion since the PRI began in 2006. This clearly proves that it is only a matter of time before full ESG integration becomes mainstream, and by bridging the disclosure gap, both the corporate sector and the investment community can work together towards sustainable development.
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