

Has sustainability become critical to business? (2)

1/16/23



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To pick up where we left off last week, this article explores the ESG concept and its components – environmental, social and governance.

ESG components

The environmental aspect shows how companies respond to climate change, how efficiently they consume electricity or heating resources, and what their waste and water management principles are. This helps stakeholders understand how a company manages and consumes resources related to the environment. Environmental indicators show how responsibly the company consumes natural resources and how its operations affect the environment, including not only its direct operations but also activities along its supply chain.

The social aspect examines how a company treats its employees and observes human rights, because a safe and healthy working environment is essential for the well-being of workers. This includes principles such as equal treatment, an inclusive and respectful working environment, and the company's initiatives to promote employee well-being and welfare. The social aspect also includes the company's goods or services, i.e. producing and advertising them responsibly and providing modern customer experience, as well as a set of issues including the company's client relationships and its contribution to local communities and society at large.

Transparent and responsible governance boosts the company's performance and helps it become more stable and productive, improve its reputation, and build the trust of stakeholders.

The governance area emphasises questions relating to the company's governance structure, e.g. how the company chooses its board and council members, how it allocates responsibility, what its remuneration policies are and how they are linked to, for instance, achieving its ESG goals. We should also mention the mitigation of conflict-of-interest and corruption risks, in particular any procedures and initiatives the company uses to mitigate these risks.

However, this raises the question of whether all these ESG aspects are equally relevant to every company. How can a company evaluate sustainability aspects that are material to it? The answer is double materiality.

Double materiality

Each company has its own key sustainability aspects. Double materiality is the approach being currently debated that views materiality from two standpoints and is much wider than the approach commonly used so far, which determines material aspects according to the company's impact on sustainability aspects.

The double materiality concept views impact in the short term, medium term and long term, including:

- Financial materiality being geared towards environmental, social and governance aspects or risks and/or opportunities – changes to the external environment affecting the company’s financial indicators
- Impact materiality determining sustainability aspects where the company’s operations and goods or services make a material impact on the environment and society.

It’s important to note that the double materiality approach is prescribed by the Corporate Sustainability Reporting Directive and European sustainability reporting standards. To meet the directive’s requirements and the standards, companies must determine their key sustainability aspects by conducting a double materiality analysis.

ESG risks

Great significance is attached to ESG risks and how they are managed.

While ESG aspects may vary from company to company, they all share a common feature: they are able to significantly affect the company’s long-term business and profitability. A company that fails to identify and manage its ESG risks may lose the trust and support of its investors, clients, suppliers and other stakeholders, and may be unable to stay in business.

ESG risks must be identified across all business levels, including the company, its business units, goods and market/region, as these may affect the company’s strategic and business plans.

The following characteristics distinguish ESG risks from ordinary risks:

- ESG risks may be less predictable and materialise over a longer period because their impact may arise gradually.
- A risk assessment is often based on historical data. For ESG risks, especially new or emerging ones, it may be difficult to find historical experience for assessing the potential impact of a risk.
- ESG risks are versatile and mutually related at macro level so they affect business in many dimensions.
- Risks may be beyond the company’s control. Responding to risk may depend on steps taken by other parties or may require a concerted effort.

PwC’s survey

A survey conducted by PwC in late 2022 on the quality and maturity of publicly available non-financial information in Latvian companies finds that 67% of the companies surveyed have identified at least one of ESG risks and are putting risk management procedures in place to mitigate those risks as far as possible.

The companies surveyed identified environmental risks such as climate change, unavailability/insufficiency of resources, natural disaster, and biodiversity. The impact of these risks extends beyond the corporate landscape.

In the social area, companies identify and manage risks associated with human rights, safe and healthy working conditions, employment trends, and workforce availability.

In the governance area, companies manage IT security risks and reputational risks, which are intertwined

with environmental and social risks, as well as cybersecurity, corruption and conflict-of-interest risks.

(To be continued)