Climate change and sustainability

How sustainability has expanded the CFO's role

Ernst & Young

Quality In Everything We Do

What sustainability means for you

The triple bottom line

Today's shareholders expect organizations to meet standards of social, environmental and economic performance

Environmental

- Energy—fuel, oil, alternative
- Water
- Greenhouse gases
- Emissions
- Waste reduction: medical; hazardous; non-hazardous; construction
- Recycling
- Reprocessing/re-use
- Green cleaning
- Agriculture/organic foods
- Packaging
- Product content
- Biodiversity

Economic

- Accountability/transparency
- Corporate governance
- Stakeholder value
- Economic performance
- Financial objectives

Social

- Public policy and advocacy
- Community investments
- Working conditions
- Health/nutrition
- Diversity
- Human rights
- Socially responsible investing
- Anticorruption and bribery
- Safety

Traditionally, sustainability issues have fallen outside the jurisdiction of the Chief Financial Officer. CFOs ran the numbers, letting others handle soft issues such as social responsibility and corporate citizenship.

But those job silos are crumbling. Investors, business customers and other stakeholders have shown a growing desire to connect a company's financial performance to its social and environmental impact. To make that connection, they have begun evaluating the company's performance in the Environmental, Social and Governance (ESG) arena, sometimes referred to as the organization's "triple bottom line."

As a result, sustainability issues and financial performance have begun to intertwine. CFOs are getting involved in the management, measurement and reporting of the companies' sustainability activities. This involvement has expanded the CFO's role in ways that would have been hard to imagine even a few years ago.

The changes stem partly from a realization by institutional investors that climate change and sustainability issues often bear directly on companies' risk profiles, their reputations and their financial performance. Equity analysts, for example, have begun to look at the sustainability practices of the companies they cover. More than 300,000 Bloomberg terminals around the world provide corporate sustainability information such as emissions data, figures on energy consumption, corporate policies and board composition. That information, until recently kept hidden or shared quite sparingly, is now available at the touch of a button.

As ESG factors are incorporated into investment analysis, companies have started to view environmental and social initiatives as contributing directly to their economic performance. CFOs and other market-facing executives will need to become more familiar with their companies' most vital ESG issues. They'll also need to prepare for hard questions from stakeholders, and to demonstrate a heightened commitment to ESG performance.

These trends are changing the CFO's role in three critical areas: investor relations; external reporting and assurance; and operational controllership and financial risk management.

Investor relations

The art of investor relations (IR) is the art of storytelling. Investors want facts about a company's profit potential; the company weaves those facts into a compelling tale that showcases its prospects in a dramatic and credible way.

Sustainability can be viewed as a new character introduced into a familiar plotline. The story is still about financial promise, but with a new twist: increasingly, a company's sustainability story is being heard and read by the same people who read its annual financial reports. Banks, insurance companies, private equity funds and other institutional investors are considering the sustainability rankings of the companies in which they invest. Managers of socially responsible investment funds are looking at ESG indicators to meet the requirements of shareholder initiatives such as the United Nations' Principles for Responsible Investment (UN PRI). Although not the only initiative of its kind, the PRI is one of the largest, with 800 signatories including large funds, such as BlackRock and TIAA-CREF, that manage more than US$22 trillion in capital.

As sustainability issues intertwine with business strategy, institutional investors are starting to view financial and non-financial performance as two sides of the same coin. Good IR can be a key factor in the price of a company's shares and the interest rate it pays on its debt. For that reason, CFOs must stay up to date on their companies' sustainability policies and initiatives and on ESG issues more broadly.

Shareholders speak out

Shareholder voting patterns provide convincing evidence of investors' belief that a company's social and environmental policies correlate strongly with its financial performance. In the 2011 proxy season, for example, approximately 40% of all shareholder proposals that were voted on focused on social/environmental issues — the largest category of all shareholder resolutions.

Moreover, these resolutions are garnering strong support. As recently as 2005, less than 3% of all shareholder resolutions on social and environmental issues reached the critical support threshold of more than 30% of votes cast. By 2010, 26.8% had hit that level. This proxy season, it was 31.6%.

Sustainability has become embedded in CFOs' traditional areas of focus.

The mutual fund industry provides a clear example of the growing support for environmentally related shareholder proposals. According to an analysis by Ceres, a non-governmental organization, average support by mutual funds for climate change–related resolutions grew from 14% in 2004 to 27% in the 2009 proxy season. Opposition to those resolutions fell from 76% to 55% during the period, reflecting a sharp departure from traditional voting policies.

Sustainability is also influencing corporate governance, as shareholders pay closer attention to resolutions that tie social and environmental performance to issues such as compensation and the qualifications of board members. One recent resolution, for example, advocated using sustainability metrics as inputs in determining executive pay, while another sought to ensure that board members had sufficient expertise to deal with sustainability and related environmental issues.

Ratings agencies evaluate sustainability

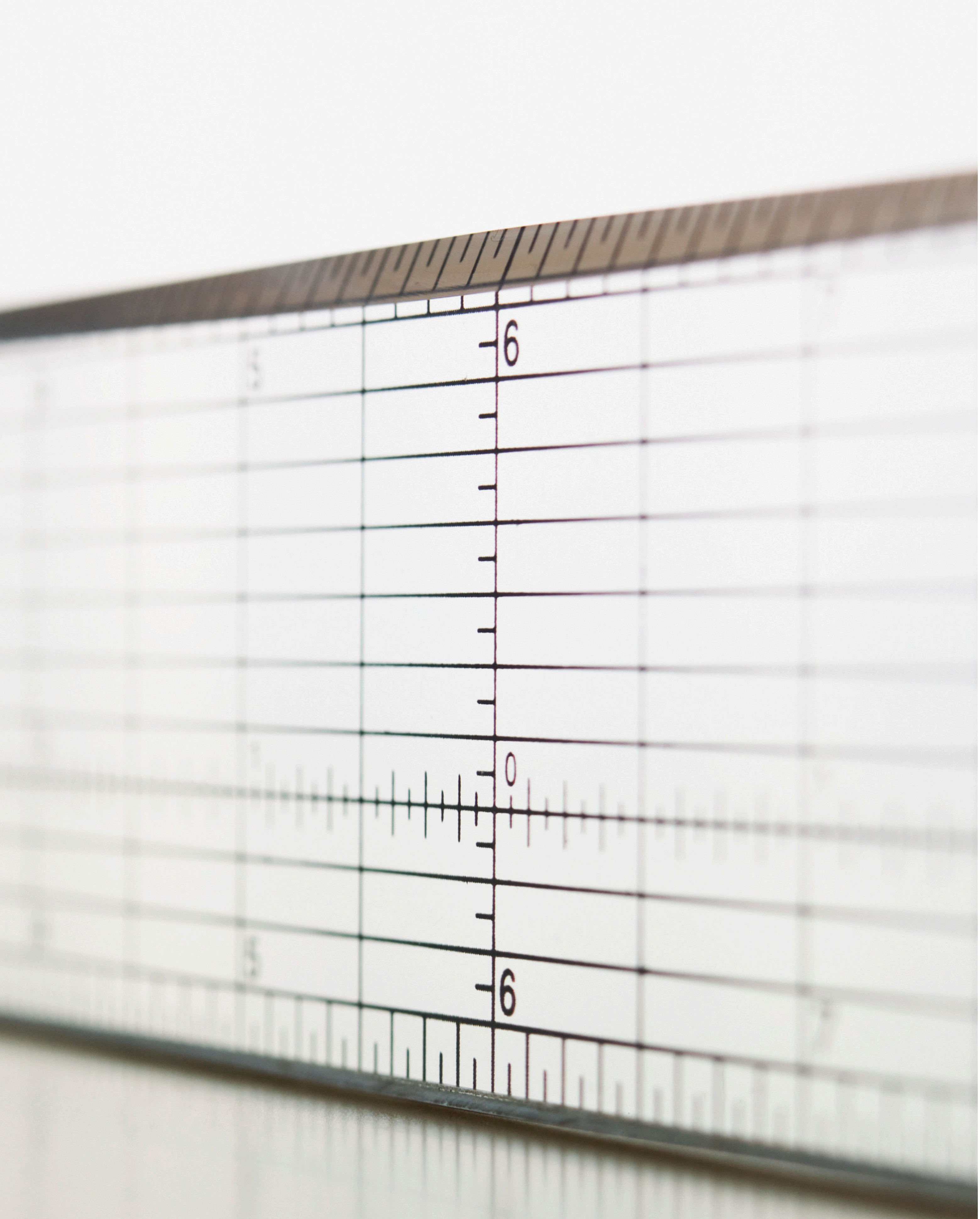
Credit-rating agencies, such as Moody's and Standard & Poor's, have long provided shareholders with a source of company information. In a departure from their traditional focus, they now want to know about companies' sustainability practices. So do the more specialized providers of sustainability ratings. The Dow Jones Sustainability Indexes (DJSI), for example, give stakeholders information about companies' social, ethical and environmental impact.

As analysts and ratings agencies incorporate sustainability performance into their research, CFOs will need to help communicate a robust sustainability story — one that's embedded in a financial framework. Inevitably, this need will expand both CFOs' responsibilities and their workloads. In addition to the DJSI, there are more specialized ratings and rankings, such as the Carbon Disclosure Leadership Index, the FTSE4Good Index Series and the NASDAQ OMX CRD Global Sustainability Index. These are just three of more than 100 ratings, rankings and indices designed to help investors and other stakeholders separate the sustainability leaders from the laggards.

All of this adds up to the proverbial writing on the wall. Market pressures are requiring IR communications to provide more in-depth sustainability reporting. Everyone in the IR department should be fully aware of all sustainability initiatives and performance metrics across the organization. CFOs and their immediate reports must help corporate IR teams in this undertaking.

Actions to consider

- Work with your sustainability team to develop a sustainability story for your organization. If current trends continue, the CFO could be the one telling it.
- Learn who's who among the specialized sustainability rating agencies in order to prioritize the ratings most vital to your organization.
- Pay attention to the sustainability-related shareholder resolutions that come up at annual meetings and advise your board and CEO on which issues to pursue.
- Take preemptive action on governance-related sustainability issues to avoid being forced to react to them.



External reporting and assurance

Transparent reporting of sustainability performance is important, and not just to investors and ratings agencies. Business customers are requesting information about a company's environmental footprint. The classic example of a large customer asking companies to disclose more ESG information is Walmart, which launched a supplier sustainability initiative in July 2009.

Among other things, customers increasingly want to know that a company's distribution model has a low carbon footprint; that its procurement policies take "fair trade" issues into account; and that its supply chain uses alternative energy sources. All of this puts pressure on companies to focus on sustainable procurement policies, distribution and logistics, and water and waste consumption, all while evaluating new sources of energy. And while each of these focus areas has potential environmental benefits, each one also has a potential financial impact. Evaluating the return on investment (ROI) of potential capital expenditures and reporting on their bottom-line impact requires the attention of the CFO's finance team.

One of the best ways to communicate corporate sustainability practices is to publish a sustainability report that centralizes all of a company's material sustainability data. More than 3,000 companies worldwide now publish sustainability reports, including two-thirds of the Fortune Global 500.

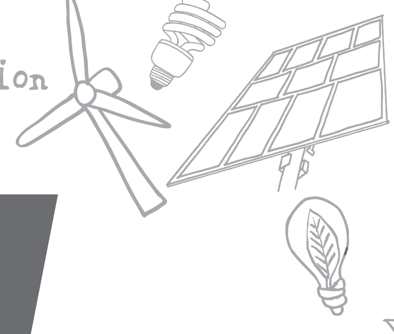
In fact, the integration of sustainability reporting with financial reporting is gaining attention worldwide. Some believe that it will be the norm before the end of this decade. It may be a voluntary trend that gains momentum, or a development driven by government regulation. Either way, the potential shift in the direction of integrated reporting adds to the importance of involving the corporate finance team in the sustainability reporting process today.

Realizing the benefits of transparency

Whether a company issues sustainability reports on a stand-alone basis or integrates them into its financial reports, third-party assurance enhances the transparency of corporate reporting, and therefore its credibility.

In a survey published by the Global Reporting Initiative (GRI), a non-governmental organization that has developed widely used standards for sustainability reporting, 82% of US companies and 66% of European companies cited transparency as the primary factor influencing their corporate reputations. That's a higher percentage than companies citing trust, product or service quality, leadership or even financial returns.

Third-party assurance improves transparency. And now, the same standards of third-party assurance that have long been used to validate financial information are increasingly being



What is sustainability worth to you? That's the fundamental question.

applied to sustainability reporting as well. Many ratings agencies consider the presence of third-party assurance in their scoring systems. The Carbon Disclosure Project (CDP), for example, makes third-party assurance a requirement for inclusion in its Carbon Performance Leadership Index, which ranks the quality of a company's climate change disclosure.

Third-party assurance mitigates the risk of misstatements associated with sustainability reporting and sends a message that reports are relevant, reliable and free from bias. While there are comparatively few government-mandated requirements for assurance of sustainability reports, stakeholders have already begun to expect that such reports will be subject to validation by credible third parties.

This is where the CFO's perspective becomes important. Most CFOs have vast experience in the world of third-party assurance providers. They know how to select the best providers and work with them effectively. They understand both the rigors and the benefits of an external audit, and are familiar with the systems and controls used in nonfinancial reporting. This experience can greatly benefit corporate sustainability teams in selecting and working with a third-party assurance provider.

Sustainability information must be consistent

Being transparent delivers benefits, but it is not without risk. Companies release information through a variety of channels — printed reports, websites, supplier sustainability indices, ratings agencies — so they must ensure that their data remains consistent across various reporting platforms.

Maintaining consistency is made all the more challenging by the global footprints of multinational corporations. If a multinational operates in 10 countries and each business unit employs different parameters to define and calculate its data, the company could end up with disparate numbers that do not allow for direct comparison. Sometimes, even ensuring data comparability within business units can be a challenge.

There are also pitfalls in how organizations characterize most of the risks associated with their business activities. For instance, most S&P 500 companies that report to the CDP identify climate change as a significant risk. A food company, for example, might note in its report to the CDP that extreme weather events pose a physical risk to its business operations in some parts of the world. At the same time, the company's regulatory filings might fail to characterize that risk in the same way.

These types of inconsistencies can confuse stakeholders. Moreover, they have the potential to damage a company's reputation, and might even result in lost business opportunities. To prevent this, CFOs must know what sustainability-related information is being reported by the organization, and must ensure that all reporting and assurance processes used for sustainability information are consistent with those used for financial statements.

Actions to consider

- Consider sustainability issues when contemplating significant capital expenditures.
- Evaluate the benefits of including sustainability information in annual financial reports.
- Push for transparency in the organization's sustainability performance, and consider obtaining third-party assurance for external reports.
- Watch for inconsistencies in sustainability reporting — across communications channels and business units — to minimize the need for restatement.

Operational controllership and financial risk management

In late 2009, the Securities and Exchange Commission (SEC) began to allow shareholder proposals to include the phrase "financial risk" in discussing environmental and other issues. In February 2010, the SEC issued guidance to companies regarding their responsibility to disclose material risks related to climate change. The guidance notes that a company's CEO and CFO must certify that the company has installed "controls and procedures" enabling it to discharge its climate change disclosure responsibilities. In other words, sustainability has found its way into the realm of controllership and financial risk management.

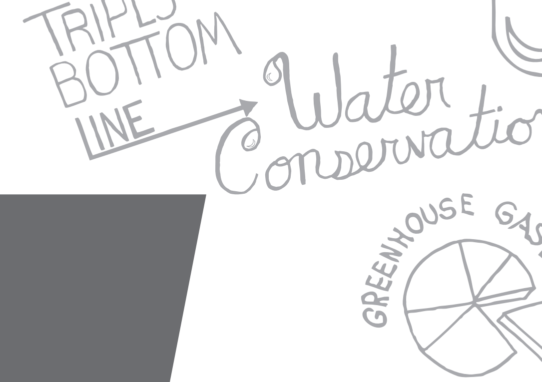
Carbon data becomes financial data

To quantify inputs and outputs related to climate change, CFOs will need accounting systems that track any sustainability-related events that are significant from a financial reporting perspective. In many ways, accounting for sustainability information already mirrors the financial accounting function. For example, a company buys water from a utility. This transaction becomes a record of the company's water use and provides a metric for its environmental impact. Another example: when a company buys hardwood from a lumber vendor, the transaction documents the company's policy of purchasing sustainable forest products. In this way, the line between accounting records and sustainability records has begun to blur.

It is this blurring effect that requires the steady hand of the CFO at the controls. Sustainability activities must now be treated like financial activities, with a controller to monitor and account for them. As yet, there is no dedicated sustainability reporting software comprehensive enough to provide the necessary level of control. For that reason, among others, CFOs will have to pay closer attention to the sustainability-related aspects of company operations.

Managing the financial risk of sustainability

As noted earlier, being transparent entails some risk. Sustainability is amplifying that risk in ways that are becoming clearer every day. Imagine, for example, that a multinational operates in a country whose chief lawmaking body passes a cap-and-trade law or institutes a carbon tax. Suddenly, the company's carbon footprint would pose a financial risk.



They say time is money. But now, sustainability is money too.

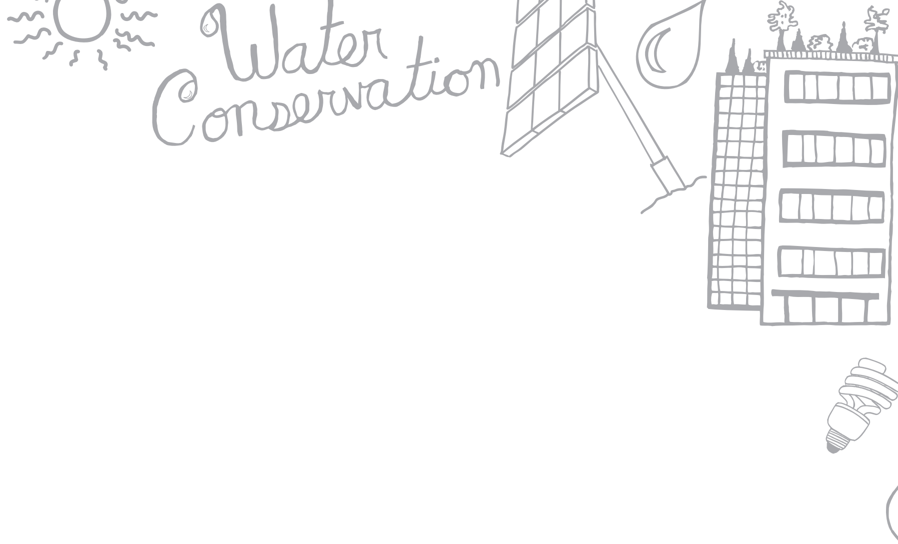
A carbon tax would force the company to confront new risks, such as asset value erosion tied to a carbon price. Each time the company introduced a new line of products or services, the CFO would have to devise a risk-based cost evaluation that took the carbon price into account. Moreover, the carbon price would affect each asset in the company's portfolio a little bit differently, depending on the asset's energy sources, generation capacity and the technology involved in creating it. CFOs would be charged with ensuring that the company's capital allocation reflected its carbon-related risks and opportunities across the entire portfolio.

When contemplating acquisitions or large-scale capital projects, companies may need to model various outcomes to determine the probable ROI or calculate the odds that an acquisition target will be subject to new regulations that would drive up its operational costs.

These hypothetical scenarios illustrate a basic truth: carbon data becomes financial data. So too will data related more broadly to sustainability. Companies will have to make sure that, like their financial data, their sustainability data adheres to the accounting principles of accuracy, reliability, completeness and consistency. Otherwise, the company will risk releasing inaccurate financial information.

Actions to consider

- Start analyzing data such as water and energy use, emissions output, employee transportation, telecommuting, virtual conferencing, copy-paper purchases, supply and distribution chain policies and practices — anything that contributes to your company's environmental impact.
- Create statistical models that help you make sense of and quantify the cost of these disparate data points.
- Keep up with new and impending environmental regulation in all of your business locations, and pay attention to how such regulations may affect your supply and distribution chain.



Needed: a sustained effort

As companies continue to recognize the benefits of sustainable business practices, they will begin to develop the analytical tools needed to evaluate and measure their sustainability efforts. As they do, their finance functions will become more deeply involved in decisions surrounding sustainability initiatives. If more reporting is legislated, CFOs and controllers will become more closely involved in sustainability as they work to manage the rising threat of restatements and associated penalties and fines.

But even if legislation does not require additional reporting, many companies will continue responding to stakeholder pressure by issuing sustainability reports voluntarily. Because reporting through multiple channels increases the risk of error, audit committees are scrutinizing the accuracy of all information going outside of the organization. The changing landscape means that sustainability, and the accounting related to it, have begun to resemble a new business function being rolled out to the overall accounting organization.

CFOs need the support of others, such as the CEO, legal counsel, and the heads of environmental, safety, IR, corporate responsibility and other functions. But CFOs are uniquely able to influence the organization, and to build a consensus toward action. Revenue generation, cost reduction and risk mitigation are typically part of the CFO's main job of preserving and increasing shareholder value. Sustainability reports often cover all of these critical elements. Accordingly, CFOs must pay attention to the content and credibility of the information contained in those reports. Savvy CFOs will advocate responsible behavior and transparent reporting, and will anticipate growing pressure to become more involved in sustainability issues that affect the organization's finances.

Five actions CFOs can take now to enhance corporate value through sustainability

[1] Actively pursue a sustainability and reporting program. Increasingly, companies recognize that implementing the procedures needed to measure, monitor and report on environmental and sustainability issues helps them create value, reduce uncertainty about future cash flows and profitability, and enhance their reputation. Companies may want to work with an outside firm to perform a diagnostic review, a pre-assurance assessment, benchmarking, and environmental and sustainability activity reviews.

[2] Ensure that those responsible for sustainability matters do not operate in isolation from the rest of the enterprise — especially the finance function. The financial organization, through its accounting system, must provide the sustainability function with the information needed to do its job. That information should be timely, accurate and complete — the very same attributes that financial accounting information should possess. No matter how the company structures these responsibilities, the CFO is responsible for providing the sustainability function with the necessary information.

[3] Enhance dialogue with shareholders and improve disclosure in key areas, particularly those related to social and environmental issues. Robust sustainability reporting can help with this. For more detailed information about sustainability reporting, please see Seven questions CEOs and boards should ask about 'triple bottom line' reporting at ey.com/climatechange.

[4] Ensure that directors' skills are relevant to the chief areas of stakeholder concern, including risk management tied to social and environmental matters. In particular, companies must communicate with shareholders. They could, for example, take advantage of the SEC disclosure rules around director qualifications to explain how the qualifications, backgrounds and skill sets of their directors — both individually and as a group — contribute to overall corporate strategy, including risk mitigation.

[5] Consider using nontraditional performance metrics, including those related to environmental/sustainability issues. Doing so could help align compensation with risk. In addition to financial metrics, performance goals should align with overall environmental strategy, including clearly defined metrics relating to energy efficiency, water usage and the reduction of carbon emissions.

Our point of view

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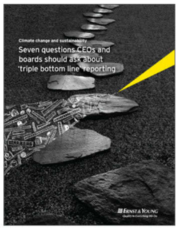
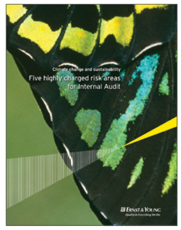
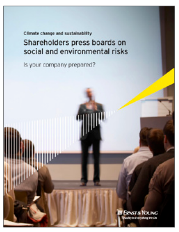


Seven questions CEOs and boards should ask about 'triple bottom line' reporting

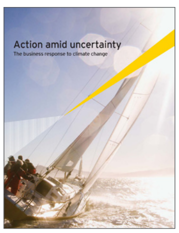


Five highly charged risk areas for Internal Audit



Shareholders press boards on social and environmental risks

Five areas of highly charged risk for supply chain operations



Action amid uncertainty: the business response to climate change

The role of tax as catalyst for change

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