COSMOS
Navigate the Compliance Universe

ethikos Volume 34, Number 10. October 01, 2020
How ethics and compliance officers interact with ESG principles

By Patrick Wellens, CCEP-I, CFE, CIA, CRMA, and Shaun McMillan

Patrick Wellens (patrickwellens@hotmail.com) is currently working as a Global Compliance Business Partner for one of the divisions of a multinational pharma company in Zurich. He is also a board member of Ethics and Compliance Switzerland.

Shaun McMillan (mcmillan.shaun@gmail.com) has a certificate from the University of St. Gallen Department of Ethics in Corporate Social Responsibility and brings her expertise working in diverse industries driving business process solutions across an entire organization.

In order to allow investors, consumers, policy makers, nongovernmental organizations, employees, vendors, competitors, insurers, and contractual counterparties to evaluate the risks and opportunities that will significantly affect a company's long-term operational and financial performance, more companies have started to disclose nonfinancial information on environmental, social, and governance (ESG) aspects of their business.

Investors typically want companies with high ESG scores, as studies have shown that companies with higher ratings outperform in the stock market.[1] Surveys of millennial respondents (an age cohort that will be a large majority of the workforce by 2025)[2] show that many (nearly 40%) of them accepted a job role because the company performed better with sustainability and it was socially responsible.[3] Many respondents indicated that if ESG was in the company's corporate strategy, it would affect their decision to stay with that company for a long period of time.

ESG reporting and ESG rating

With the implementation of EU Directive 2014/95,[4] large multinationals (listed on the stock exchange, banks, insurers, and other enterprises designated by national authorities as public interest companies with more than 500 employees) are required to include nonfinancial statements in their annual reports from 2018 onward.

Most businesses create a separate sustainability report, while others create an integrated annual report that includes financial and nonfinancial statement information. The nonfinancial statement information reporting typically includes detailed information on a company's ESG performance:

- **Environmental performance** focuses on the contribution a company makes to climate change through greenhouse gas emissions, waste management, energy efficiency, natural resource conservation, and humane treatment of animals.
- **Social performance** pertains to human rights, supply chain labor standards, exposure to illegal child labor, workplace health and safety, human capital development, and relationships with local communities, supplemented with volunteering activities.
- **Governance** addresses the use of accurate and transparent accounting methods; tax disclosures by country; business ethics; anti-bribery and corruption; board ESG performance targets; and remuneration, political contributions policies, and disclosures.

Companies obtain an ESG rating through a multistage process, as follows:

1. Companies disclose their annual sustainability report on their website. The annual sustainability report is typically referenced to a reporting framework (e.g., Global Reporting Initiative, Sustainability Accounting Standards Board).
2. Rating agencies (e.g., Sustainalytics, MSCI) automatically rate companies based on disclosures in the public domain (annual sustainability report or via company website), whether the company would like to have such ratings disclosed or not.
3. The rating agencies conduct their own media search and identify adverse media. A draft ESG rating report is then sent to that company for further comment.
4. The company provides feedback and additional supporting information (e.g., information that is not disclosed on the website) to the ESG rating agency.
5. The ESG rating agency makes their final assessment of a company's ESG performance and publishes the company's ESG report.
6. The final ESG rating reports are then sold to interested parties such as media companies, proxy advisory firms, or made available on the rating agency's portal for their clients.