TRANSFORMING THE MINDSET TO BUILD TRUST
Not ESG, But G(EES)

Dr. Yılmaz ARGÜDEN - Chairman, ARGE Consulting and Trustees of Argüden Governance Academy

Building and maintaining investor and stakeholder trust is key for sustainable success. Investor relations (IR) professionals play a key role in this process. They provide not only a key interface between the company and the investor/stakeholder community to communicate the company's strategy and performance, but also the IR department is responsible for forwarding company stakeholders' input to the management.

Companies are typically subjected to performance evaluations based on the financial outcomes of their activities during the recent past, albeit mostly focused on financial outcomes. Recently, sustainability performance has become part of the key criteria for numerous investors. [1]

Corporate interest in sustainability issues started out as **'nice to have'**, as part of their social responsibility programs and to build their corporate reputation. However, those who have taken it seriously as a board & CEO responsibility soon understood that paying attention to sustainability issues was in fact a great **'risk management'** technique, particularly since avoidance is much more economic than repairing corporate reputation after a significant failure. More recently, some forward-looking business leaders began to view the challenge of sustainability as an opportunity for **'value creation'.**[2] They came to realize that if sustainability issues are becoming relevant for large numbers of people throughout the globe, addressing them properly and finding solutions for global problems would be a good business case for satisfying this global need.

As external pressures, including resource scarcity, and access to information continue to increase, how corporations respond to sustainability challenges will determine their long-term viability and competitiveness. As the world continues to get smaller, mutual interdependence between the corporations and their stakeholders grows larger. To achieve success, institutions increasingly rely upon the utilization of not only their own resources, but also the resources of others. To be able to gain access to the resources of others, institutions need to create trustworthy relationships. Therefore, the key to success and development is gaining the trust of present and potential stakeholders. These stakeholders include not only shareholders, employees, labor organizations, and customers, but also those who provide credit to the company, those in its supply chain, and the governments where the business operates; in short, individuals and organizations in all parts of society.

In order to embrace a proper understanding of sustainability and incorporate it into our corporate strategy we need to move beyond the current vernacular of ESG.

Widening our perspective for a more comprehensive view of sustainability: Not ESG, but G(EES)[3]

A sustainable global economy combines long-term profitability with ethical behavior, social justice, and environmental care. When we look at the state of the world today – climate change, deteriorating water resources, plastic waste, income inequality, gender inequality, and corruption – it is evident that institutions need to assume responsibility for sustainable development and act.

[1] https://hbr.org/2019/05/the-investor-revolution
[2] https://www.weforum.org/stories/2023/02/to-make-sustainability-a-reality-businesses-must-focus-on-long-term-value-creation/
[3] Harvard Business Review – Türkiye, April 2022 "Board and Top Management Ownership of Sustainability is the Key for Sustainable Success" by Dr. Yılmaz Argüden & Gizem Oskay Argüden

For corporations to truly contribute to a sustainable future, we need to widen the lens through which we view sustainability. Sustainability requires decision-making processes incorporating all potential impacts of a company, incorporating the positive and negative externalities into its decision-making processes, and avoiding short-sightedness and selfishness.

This means:
• Adopting a comprehensive view of how a company creates value beyond financial measures to include economic, environmental, and social outcomes throughout the value chain,
• Adopting a long-term perspective and incorporating different time horizons into strategy and target-setting processes,
• Considering direct and indirect impacts of the company's decisions and actions,
• Becoming more inclusive by considering the impact of all their decisions and actions on all stakeholders, current and future,
• Taking responsibility for managing and positively influencing their value chain and ecosystem and opening to new ways of collaboration to solve sustainability challenges.

Reframing the sustainability debate:
Not ESG, but G(EES)

Sustainability is closely linked to the ESG acronym, directing companies to focus on reporting on environmental, social, and governance issues regarding their sustainability impact. However, ESG acronym and reporting has several impediments, and it does not reflect a comprehensive and integrated approach to how companies should approach sustainability. There are two main reasons why ESG reporting is falling short:

a. **F (Financial reporting) & ESG (sustainability reporting) separation suggests that sustainability is not viewed holistically and is not fully integrated into the decision-making processes:**

• Separating financial reporting from sustainability reporting positions ESG reporting as an adjunct activity. Analysis and management of environmental and social impact should not be considered an adjunct to financial impact but an integral consideration in all decision-making. Since if environmental and social issues are material to the company, they will have an impact on the financials of the company as well. Sustainability reporting should not be limited to ESG but should focus on reporting the company's impact across the value chain economy, the environment, and society. Connectivity is key to understanding the interrelation between economic, environmental, and social impacts on the financials of the company.
• Financial reporting typically does not encompass the total economic impact of a company's operations: A more comprehensive and integrated view of economic impact would include the value chain as well as a broader range of stakeholders, including operating geographies and communities in which the company operates. Internalizing this perspective of managing the impact of our actions would allow companies to look from a wider lens that would enable more innovative and effective solutions to sustainability issues by mobilizing stakeholders and assuming responsibility for transforming their value chain.

b. **The G in ESG refers to a limited governance definition; adopting a more comprehensive view of governance can enable more effective management of sustainability:**

Governance involves much more than compliance; it is a culture of trust and a climate to nourish such a trust culture. As such, good governance needs to be continuously improved and the climate for good governance needs to be protected not only within the organization, but also in the community as a whole.
• The ESG acronym shows a limited view of governance as an additional impact dimension. Rather than a separate impact domain, governance is a framework for providing guidance and oversight over all decisions and actions with economic, environmental, and social impacts. Current reporting practices on governance encompass issues such as anti-corruption, but the more important focus should be how sustainability is governed (the governance of sustainability).
• Labeling **G** for governance as one of the concepts along with Environment and Social (ESG), does not encompass how we should provide governance to all our decision-making and their implications for **E**conomic (financial outcomes for the company as well as economic development for the whole value chain), **E**nvironmental, as well as **S**ocial domains. Therefore, the definition of **G** should be a central, overarching category and require looking at the whole through an integrated thinking lens.

Therefore, a more appropriate acronym would be **G(EES),** prioritizing the governance of sustainability impacts (economic, environmental, and social impact). This language change would instill a proper understanding of good governance that needs widening our perspective for a more comprehensive view of sustainability.

Sustainability Governance Scorecard (SG Scorecard): Measuring not WHAT, but HOW

While I strongly suggest that we utilize G(EES) to refer to sustainability reporting, I am fully aware of the broad utilization of ESG. The growing popularity of ESG investing has led to a surge in ESG rating and ranking providers, such as MSCI, Sustainalytics, ISS, and Refinitiv. These firms evaluate companies' ESG performance, risks, and opportunities, providing reports that investors use to guide their investment decisions. Some funds directly track specific ESG scores, while others integrate these ratings into their own analysis. Because each provider uses its own methodology, a company's ESG score can vary significantly between different rating providers.

A key difficulty with measuring sustainability issues is that sustainability performance is **context specific** and **multi-dimensional**. Therefore, it is difficult to measure and benchmark. Yet, the key to better performance is measurement and benchmarking. Therefore, it is crucial not only to assess only **WHAT** results were achieved, but also to focus on **HOW** they are achieved to assess their impact on building trust. Gaining the trust of stakeholders for recurring activities every year significantly improves performance in the future.

Sustainability Governance Scorecard©[4] (SG Scorecard) was developed to speed up peer learning by focusing on **HOW** rather than **WHAT**, as the answers to **HOW** are transferable across industries and geographies and therefore **enable benchmarking and speed up peer learning.** SG Scorecard analyzes where the Global Sustainability Leaders[5] (GSLs) stand with respect to their governance of the sustainability issues and to identify and highlight good examples to speed up learning from the peers. The SG Scorecard was based on public disclosures provided by the annual reports, sustainability reports, and web sites of these GSLs and over 300 questions were answered by reviewing these information sources. Our evaluations of the questions were shared by the investor relations departments of the Global Sustainability Leaders for their review prior to the publication.

Good sustainability governance is the key for guiding, overseeing, sound decision making, and continuous learning processes in the company. The SG Scorecard identifies and highlights good examples of sustainability governance by leading companies to facilitate peer-to-peer learning and taking action on sustainability issues. It seeks answers to critical sustainability governance questions such as:

- How do the companies report their sustainability performance? Do they report only single year results or trends or even better targets?
- Are they disclosing policies or only the results? Do the policies cover all relevant dimensions? Has there been a stakeholder engagement process and board review for materiality?
- Is the coverage of implementation comprehensive? Does it cover all areas such as environment, social, anticorruption etc., in all its operations including emerging markets, supply chain, and throughout the product lifecycle?
- Do they publish a board skills matrix and is sustainability one of the key skills sought on their boards?
- Have they presented linkages between their risks, value creation, and SDGs?
- Are the non-financial KPIs linked to executive compensation?
- Do they incorporate SDGs into their sustainability strategy process? Which SDGs attract the attention of the leading companies? Which ones are lagging?
- Is there a continuous learning process to improve their overall governance and specifically performance with respect to the SDGs?

[4] Sustainability Governance Scorecard, Dr. Y. Argüden, Dr. F.Ö. Şen, G. Argüden, K. Koldemir, P. Ilgaz, Dr. E. Erimez, Ç. Karanberk; Argüden Governance Academy publication #14, 2019

[5] 150 companies who operate in 10 different industries and are included in the sustainability indices of stock exchanges in China, Germany, India, South Africa, Türkiye, United Kingdom, and United States of America, all of which are signatories of the Sustainable Stock Exchanges (SSE) initiative.

The Model evaluates the comprehensiveness of sustainability initiatives (all processes including policy, KPI and target-setting; all stakeholders including communities and the environment, all geographies in the company's jurisdiction, value chain including the supply chain and product life cycle); as well as the breadth and depth of sustainability reporting practices. Furthermore, the model provides a view on progress towards SDGs by evaluating which companies have integrated SDGs into their strategy process and which SDGs are leading vs lagging in terms of company engagement.

SG Scorecard has two key conclusions:

• There is **significant room for improvement in the effectiveness of execution and accountability** of the sustainability programs of even the leading companies, let alone the large number of enterprises all around the world.
• There are **extensive peer-to-peer learning opportunities** based on good practices shared by the Global Sustainability Leaders on how they approach their sustainability efforts.

We also find that best-in-class companies:

• Integrate sustainability into their core **value creation model** and lead the way in extending their strategy and management beyond pure financial outcomes to encompass economic, environmental, and social related factors that are critical for the future viability of their organizations.
• Understand that **engaging stakeholders** is the key to obtaining the social license to operate in the 21st century and engage openly with stakeholders, including their communities.
• Conduct **materiality analysis** to gather insight on the relative importance of environmental, social, and governance issues to not only prioritize their sustainability effort, but also to inform sustainability reporting and communication with stakeholders.
• Ensure that their boards are fit to drive change towards a sustainable business by having **diverse boards** (age, tenure, gender, ethnicity, cultural background, geographic, functional, and industry experience).
• Show commitment by **setting targets for sustainability performance** and report their targets based on geography.
• **Align incentives** by including sustainability KPIs in executive compensation.
• Ensure **comprehensiveness of policy and implementation** throughout the value chain including the supply chain, the product lifecycle, all stakeholder groups, all levels of the organization as well as geographic coverage and reporting of sustainability performance.
• Ensure **board oversight** responsibilities cover environmental, social, and governance issues which are core to sustainable value creation.
• Establish a **learning loop for continuous improvement** and create a climate of learning with measurable indicators (trends, benchmarking).

In short, good governance of the sustainability issues is the key to having the executives and the boards of directors fulfill their fiduciary, ethical, and moral responsibilities for a sustainable future. These are critical not only for the survival of the corporation that is entrusted upon them, but also for the survival of humankind and our planet for a sustainable future. We all have a long way to go, and we can definitely speed up learning by identifying and adopting good practices from our peers.

IR professionals could play an important role in this transformation by helping refine sustainability strategies and disclosures. Investors utilize sustainability factors to assess the long-term risks and opportunities of their investments. Therefore, they need periodic updates on a company's long-term sustainability strategy when there are material developments to report. Integrated reporting would be a useful tool to demonstrate the alignment between a company's sustainability and business strategies. Furthermore, in line with the International Sustainability Standards Board (ISSB) standards, integrating sustainability information into core financial documents will be crucial for effective communication.