# Lynk-letter

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## Linking ESG Metrics To Financial Performance

CFOs, CAOs and Controllers are asking how ESG (Environment, Social & Governance) disclosures relate to financial statements. Currently, there are many existing sustainability reporting frameworks and it is difficult to focus on what is appropriate from a financial perspective.

Sustainability reporting frameworks such as GRI (Global Reporting Initiative), the UN Global Compact, TCFD (Task-Force on Climate-Related Financial Disclosures), and SASB (Sustainability Accounting Standards Board) provide guides for companies to disclose sustainability topics such as climate change, community involvement, governance practices, or diversity & inclusion that impact many stakeholders. Of these frameworks, SASB targets investors as its main audience with industry-specific standards that are identified, developed and managed in a methodology that is familiar to investor-owned companies. This means that SASB ESG metrics require materiality, are decision-useful and have a high likelihood to impact a company's financial statements.

For example, a common ESG disclosure topic in the Extractives and Minerals Processing sector (based on SASB's industry classification system) is water management. Within this sector, in the oil & gas services industry, two of the specific water management disclosure metrics are 1) volume of water used in operations, and 2) percentage recycled. Due to the large quantities of water needed for production and services, companies in this industry know that water usage represents a business risk that needs to be managed through technology, recycling methods, and/or other innovative initiatives.

By measuring this environmental metric, a company can then focus on innovation and processes that translate to operational efficiencies. In turn, these efficiencies reduce costs, which may impact the current financial statements in two ways: 1) reduced operating expenses, and 2) potential increase in R&D expenditures. See the following figure:


Further, a financial impact could be seen in the valuation of the company. A company may need to perform a discounted cash flow (DCF) analysis for valuation purposes. Because DCF analyses are based on basic financial statements, reduction or increases in expenses would impact net cash flow. In addition, in the process of determining the company's discount rate or the weighted average cost of capital (WACC), the company's approach to water management may impact the risk profile (less likely to suffer from water scarcity events). Even when the industry or peer companies might have a higher risk rate, a specific company risk rate will be impacted positively if a company (as compared to others in its peer group) has invested in water recycling processes that improve its short and long-term performance.

Companies can start with the SASB standards to determine whether the industry specific ESG metrics are in fact material to their financial statements. By focusing on financially-material metrics, companies can save time and money and can provide investors with decision-useful sustainability information with enhanced disclosures. The SASB ESG reporting standards provide CFOs the business-useful option that links sustainability disclosures to financial statements and market value.