Sustainability – Why it Matters to Finance Professionals

By FRANCESCO INGARSIA AND DR. ZHEN HUANG

Until recently, the common perception of many finance professionals on sustainability was that the burden fell on someone else, like human resources, EHS, or compliance, and was not an issue that should keep a CFO up at night. This dynamic has changed, and in today's world, sustainability has also come to the profession of "bean counters".

Awareness of the impact of human economic activities on the environment in modern times goes back to the beginning of the 1970s. One of the first steps towards a greener perspective was the appearance of the Club of Rome's "Limits of Growth" by researchers Donella and Dennis Meadows in 1972. In the 1980s, many scholars developed methods to determine the ecological impact of economic activities such as "environmental accounting" and "eco-balance sheets." The advance of information technology then helped the development of new software applications, which allowed Western research institutes and universities to build master's degree programs. One of the first, the Technical University of Nuremberg in Germany, established a university chair in "environmental-oriented management" in 1994. One of the authors of this article worked as a teaching assistant, and oversaw the rollout and training of GEMIS - Global Emissions Model for Integrated Systems - a tool for environmental cost and employment analyses of energy, materials and transport systems. "Green controlling," in the 2000s, found its way into the broader management theory of finance students, and companies began to see "green" as a competitive advantage rather than a cost factor. Today, sustainability has officially gained the attention of the general public thanks to the climate change debate and worldwide movements like Fridays for Future and Extinction Rebellion.

What is Sustainability Really?

While precise definitions of sustainability vary widely, at its core it's about protecting and strengthening foundations for long-term success - whether for individuals, communities, companies, or future generations. In the corporate world, it's about planning so companies can make the right decisions today to avert the problems of tomorrow. It also refers to the ability of companies to do business in ways that minimize social and environmental harm, while maximizing the business opportunities to sustainability-related challenges including climate change, resource scarcity, the collapse of critical natural ecosystems, and mounting global demands for food, water, energy, housing and transportation.

Many companies today are embracing sustainable management and following the lead of global organizations that aspire to have a positive influence on economic, social and ecological development. The United Nations' 17 Sustainable Development Goals (SDGs) form the foundation of many company's sustainability guidelines. Beyond this, corporations embrace the principles of the UN's Global Compact and are guided by the values and attitudes of the National Action Plan for Business and Human Rights, the UK Modern Slavery Act, the German National Sustainability Strategy and the objectives of the Paris Climate Change Agreement.

So, how should CFOs and other senior finance executives, respond to sustainability? What is their role in pushing sustainability and the systematic change that needs to happen in the larger financial industry? What are the business challenges that matter to them? And most importantly, which practices are best suited to help realize sustainability-driven opportunities for improving business performance? To safeguard assets, the CFO's primary role is to manage risk and improve corporate performance. Done in the right way, sustainability has the potential to assist finance professionals facing pressure to reduce short-term costs while building the financial foundation for long-term profitability. Sustainable thinking, in this context, gives businesses an opportunities in three major areas: (1) risk management, (2) capital productivity, and (3) innovation and growth.

Enhancing Risk Management

Many CFOs carry the crown of "chief risk officers" and bear the responsibility of establishing an effective framework to manage risk that can impact the company's financial health. Those business risks might derive from external factors like global megatrends or government regulation, while others might originate from specific customer markets or internal factors.

Sustainability-related risks include global climate change, uncertainty about future fossil fuel supplies, resource scarcity, insecure food supplies, ecosystems and decline in biodiversity. In China, as well as the West, more focus on those risks has led to a tightening of the regulatory environment, increasing costs to comply, price fluctuations and the availability of products or services. The awareness and expectations of other stakeholders like investors or credit rating agencies and the general public - due to the influence of social media - have also increased over the years. Those challenges might

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cause substantial negative financial impact by risking operating costs, reputation or supply chains. Integrating them in the overall risk management and periodic reporting/controlling cycle help companies to handle them proactively.

Identifying and implementing sustainability-related measures can improve the foresight needed to limit high-risk products or production choices for the company. Sustainable thinking also increases the company's chances of avoiding costs from property damage, accidents, restoration and reputation damages, as well as helps to prevent supply chain disruptions. "Stranded assets," such as property, plant and machinery, are particularly at risk due to new regulations, market forces, technological innovation, and changes in societal norms and the environment. To internalize potential threats, the framework of the Committee of Sponsoring Organizations' (COSO) can provide key direction for companies as it differentiates between strategic, operational, compliance and reporting-related risks.

Optimizing Capital Productivity

Reducing, replacing and recycling - sustainability offers unique opportunities for companies to cut costs, improve efficiency, and reduce or even eliminate waste. Companies can target compliance costs by cutting toxic emissions and operations to run facilities through more efficient resource handling like water, wastewater, energy, and heat used in buildings, machinery, transportation and data centers. Another opportunity sustainability offers is supply chains optimization, which leads to a reduction in environmental impact from less transportation and warehousing costs, as well as lower expenditures for special freight due to less fluctuation in material flows.

By addressing sustainability issues at an early stage of a capital investment decision, costs are minimized, which from an investor and lender perspective is especially important. All of these optimizations also have a positive effect on employees, providing them with a common goal to rally behind. It also helps to drive change and improvement across boundaries by enhancing collaboration and preventing "silo-thinking."

Cultivating Innovation and Growth

While some trends pose risks for existing business models, sustainability gives way to opportunities by opening new markets and customer relationships. Customers learn from the value proposition of new products, that is less energy consumption during the product life-cycle, or the value of sustainability for their own business, i.e. continuous monitoring of production processes for preventive maintenance purposes. In addition to improving existing products and enhancing capital productivity, sustainability might also lead to new sustainability-driven products and business models that drive growth, like the e-mobility trend we see today. This can also be supplemented by M&A activities to combine the know-how of the company in various fields with other innovative companies.

Regulatory changes have led to new markets for ecological-related services and sustainability-financing schemes such as carbon-trade and power purchasing agreements, garnering much attention from finance professionals. And as the general public learns more about sustainability, greater importance will be placed on its innovation and growth.

Transforming Traditional Financial Planning and Analysis

In reality, the additional value created from sustainability measures—reduced risks, higher capital productivity and increased business growth—is not always easily quantifiable. This is especially challenging when it comes to earmarking the financial impact of upgraded corporate and brand reputation, employee satisfaction and engagement, and societal and environmental aspects. Sustainability-related projects, though promising at the initial phase, do not always reach the company's measurements such as internal rate of return, net present value or payback period. One of the reasons lies in the fact that the price of a specific resource like water does not reflect its true economic value. In these situations, strategic thinking and foresight from the executive management team should take precedent despite an unclear financial assessment. Despite or because of those limitations, companies try to bring sustainability consideration into business cases in different ways. One approach is to set aside dedicated funds for sustainability-related investments. Another is to add the usual key financial performance indicators, introduce qualitative scoring models, or to reduce hurdle rates. New sustainability-related indicators like return on resources (ROR) or energy returned on energy invested (EROI) can also be added to complete project evaluation. Lastly, to work-around the incomplete pricing of externalities for resources, some companies set internal prices, like the cost of carbon emissions.

The complexity of sustainability-related project evaluation goes beyond the conventional cost-benefit analysis. At its best, it requires linking financial, environmental and societal aspects from a single investment project to the annual budget and long-term business plan. In this respect, finance professionals, as data collection experts and with the help of digitalization, can support their organizations to find smart solutions to better collect sustainability-related data, such as emissions, energy, water, waste and impact on ecology. This data can next be used to enhance decision-making and strategic planning, and is why sustainability matters to finance professionals.

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