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Measurement & Evaluation

The Free Market Must Account for Environmental and Social Impact

Companies, investors, and consumers need an expanded set of metrics that more broadly and accurately measure risk, return, and value. In addition, they need practices that support relevant data collection, management, and integration into strategy and decision making.

By Sara Olsen, Clara Miller & Coauthors | Fall 2019

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Since the formalization of standard accounting principles, businesses and investors have applied generally accepted methods to measure and understand value. This knowledge, in turn, contributes to optimizing the economic activity that creates value.

Yet traditional financial accounting tools fail to inform investors and businesses about the full nonfinancial effects—or even the full range of financial risks—that arise as a result of their activities. And these effects and risks are escalating. It is no accident that all is not well with the global economy. Consider a few examples: Eight individuals own as much wealth as the poorest 3.6 billion humans; 44 percent of Americans do not have enough savings to cover a $400 emergency; the United Nations estimates that the world may have as few as 60 agricultural harvests left because conventional farming methods strip soil fertility; and climate change poses threats across the spectrum of risk: agricultural, flooding, migration, supply chain disruption, and more.

Guiding economic activity with accounting tools that are largely blind to environmental and social values is unacceptable. On the investments front alone, more than $12 trillion in assets are managed with the aim of advancing social and environmental goals. The manifest growth of this market—38 percent from 2016 to 2018—demonstrates that the social and ecological effects of business and investment activity are impressing more and more investors and shareholders. If financial accounting is at the heart of the "operating system" on which the global economy runs, the environmental and social effects of economic activity must become an integral part of that system.

Companies, investors, and consumers need an expanded set of metrics that more broadly and accurately measure risk, return, and value. In addition, they need practices that support relevant data collection, management, and integration into strategy and decision making. To fill these gaps, we must supplement conventional financial accounting with methods that track in more or less real time all the significant effects of economic activity. Happily, much work has been done over the years on measuring, managing, and valuing social and environmental effects in the context of private sector activity. But these efforts have been overlapping and somewhat disjointed, leading to paralysis and confusion even among businesses who were interested in assessing the total impact of their activities.

To resolve this problem, a large number of actors—more than 2,000 individuals, businesses, philanthropies, investment organizations, and standards bodies—in 2017 embarked on an ongoing, collective effort to define the concept of "impact" in impact investing; in environmental, social, and governance (ESG) reporting in the capital market; and in business management. This initiative, called the Impact Management Project (IMP), is both a broad practitioner community and a structured network composed of standard-setting bodies. It marks the emergence of a new business discipline of *impact measurement and management*, or simply *impact management*, which promises to transform the way value is understood.

New Fundamentals

Many different organizations have pioneered the creation of new accounting metrics that undergird the IMP's efforts. The Sustainability Accounting Standards Board (SASB) standards, the Global Reporting Initiative (GRI) standards, and B Lab's B Impact Assessment, provide consensus-based sets of criteria that measure the environmental, social, and governance (ESG) policies and practices of companies big and small. Organizations such as the United Nations Principles for Responsible Investment (PRI) and the International Finance Corporation (IFC) have defined principles of practice that investors can use to manage the social and environmental effects of their investments. And the Natural Capital Coalition, the Social & Human Capital Coalition, and Social Value International (SVI) have developed protocols and consensus- driven, field-tested principles and methods to assess the relative values of environmental and social outcomes and impacts.

These advances, in turn, have informed the work of a broader ecosystem of actors. First, there are groups working to expand impact investing, such as the Global Steering Group for Impact Investment (GSG), the Global Impact Investing Network (GIIN), the Impact Investment Exchange (IIX), and Toniic. Second, there are efforts to ground social and environmental outcomes in context—whether for regional priorities to achieve the Sustainable Development Goals (United Nations Development Programme [UNDP]), for systems to facilitate corporate efforts to address these goals (World Benchmarking Alliance), for intended beneficiaries of these and other efforts (FeedbackLabs), for enterprises and beneficiaries within certain fields (the Social Performance Task Force [SPTF]), or for those within any given setting and context (the American Evaluation Association [AEA]), its global peer organizations, and numerous academic institutions). Third, there are entities seeking to deliver impact management services to the market, such as private sector accounting and audit firms, data management platforms, data collection tools, and other providers too numerous to name.

Given the sheer number of people and organizations contributing, the IMP's progress in developing a global consensus on a set of shared fundamentals for impact measurement, management, and reporting represents a remarkable achievement. Most significantly, the IMP has helped to define what impact is. Impact is a change in an important positive or negative outcome for people or the planet. It has five dimensions: who is affected, what is changing for them, how much it is changing over what time period, the contribution of our activity to the change, and the risk that the impact may not be what we think it is. An overarching tenet of impact management is that the people whose lives are most affected by an investment or enterprise must be involved in decisions about what effects to measure and how. This concept is called *constituent voice*. It may seem obvious, but because ensuring their participation takes time, effort, and expertise, it requires explicit commitment.

In furthering the IMP's consensus-building effort, we have found that there are three basic elements to the emerging accounting system:

1. Environmental, social, and governance (ESG) accounting | ESG typically refers to the measurement of an entity's efforts to enact best practices with respect to ESG factors through its direct operations (e.g., employee health and safety, gender diversity), its products (e.g., consumer protection), and its distribution and supply chain (e.g., human rights protection). ESG is typically assessed using a predetermined list of indicators of these practices, and such lists now exist, as do rankings based upon them. A range of businesses, from tiny startups to large multinationals, now report publicly on these practices.

2. Accounting for impact | Beyond measuring and disclosing their ESG performance, companies are beginning to measure and report on their specific positive or negative impacts, particularly ones that affect pressing social or environmental challenges. The scope of impact accounting varies according to the nature, size, and complexity of an undertaking. Impact analysis of projects, products, or services, for example, differs for small companies and large multinationals.

Although it is impossible to come up with a master list of predetermined indicators to cover the particular impacts of every business in context, IMP participants and supporters have reached a shared understanding of the dimensions of impact performance that matter for a complete and comparable picture (and therefore the types of data to collect, organize, and disclose to stakeholders) and on general principles that can guide practitioners in their judgments about what to measure, and how to measure it, in any given context.

3. Accounting for the ESG-impact-financial-performance relationship | Frameworks to account for and understand the relationship between ESG and impact, on the one hand, and financial performance, on the other, now exist. Whether an investor focuses on the ESG factors that are material to financial performance in the near term (the way the Sustainability Accounting Standards Board does) or sets out to measure and manage the full range of interaction more broadly and strategically (the way Integrated Reporting does), it is clear that environmental and social factors affect financial performance—and vice versa. Disclosure frameworks make this relationship explicit and transparent.

Lifting Up the New System

Imagine a world where businesses and investors across the board took up this consensus and regularly accounted for their impacts and ESG performance. With this knowledge, investors could favor companies that adopt a larger and longer-term perspective, operate sustainably, and link their capabilities to the achievement of widely shared human development goals. Consumers could choose products and services in light of their full social and environmental cost and benefit. And managers and boards could guide their companies based on their net contribution to both shareholders and other stakeholders.

This world can be realized. This year, many major global standard-bearers for the disclosure and management of ESG performance and impact came together to support the emerging market to measure and manage impact. They are collaborating to align their existing standards for data collection and management in light of the IMP consensus. All partners in this effort provide their standards and guidance as a public good to their constituents.

As the practice of impact measurement and management grows, its standards, principles, and frameworks are quickly moving from optional supplements to financial accounting to necessary anchors of it. This new, evolving set of tools, along with their broader reckoning of risk and return, will enable a powerful range of actors to participate in facing down the world's existential problems and realizing its noblest aspirations.

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