



# Integrating sustainability into financial valuations

ESG voices podcast series

## Host

*Hello, and welcome to another episode of ESG Voices. This podcast series addresses the opportunities and challenges within ESG through interviews with ESG specialists from KPMG and beyond.*

*Throughout this series, we will discuss a broad range of environmental, social, and governance issues, aiming to support governments, businesses, and communities in creating an equitable and prosperous future.*

*Sustainability-related risks and opportunities are a key driver in business and investment decision-making, with the potential to both incentivise and scale capital allocation. But companies and investors face challenges translating complex environmental and social change into clear financial effects and forecasts, while also navigating complex political and economic headwinds.*

*The WBCSD's Corporate Performance & Accountability program works with member companies and partners to streamline and accelerate the integration of sustainability-related impacts, risks and opportunities into business and financial decision making to drive capital allocation for transformation at scale. This includes a focus on transparency, transformation and aligning finance and value as well as convening CFO, GC and other executive forums. As part of this effort, the Corporate Performance & Accountability team is convening a group of experts from professional advisory firms, investors, companies, standard setters, and academia to shape best practice on the integration of sustainability risk and opportunities in financial analysis and valuation.*

*In today's episode, we will hear from Simon Weaver, Global Head of ESG Advisory, KPMG International and Partner, KPMG in the UK and Fiona Watson, Vice President Corporate Performance & Accountability, WBCSD — who will share insights and reflections on this crucial valuation topic, this is an area with much to discuss, so let's jump right in.*

*Fiona, could we start with you?*

## Fiona Watson

Thanks for the opportunity to speak with you today. And this is such a critical topic, this concept of valuation and valuing sustainability has been around for ages. And in fact, it really informs is at the heart of the work that we're doing on the Corporate Performance and Accountability program. It's fundamental for gaining competitive advantage from being more resilient and more sustainable, and that really fits at the heart of enhanced corporate performance and accountability, which is what we're striving for, uncovers transparency and transformation as well as aligning finance and value. So, it's systemic, it's critical, and it's fundamental to what we're all trying to achieve. Last year, we were delighted to work with KPMG on starting to dig into that with the business case of sustainability. And that was a fascinating piece of work to do and to be a part of. We hope has been helpful and starting to get minds orientated towards this. And I think, Simon, you've been working with a number of your clients on delving deeper into those concepts.

## Simon Weaver

Yeah, no, absolutely. Thanks, Fiona, and great to be in the conversation today. So, if I kind of take a step back for a moment and think about the overriding principle of what we're doing at KPMG when it comes to sustainability. It's all about how do we make ESG or sustainability the water mark of everything we do, and do the same for clients. And we are, or a lot of us are accountants. So therefore, valuation is at the heart of that and ultimately make it a watermark of financial valuations is so critical. And that's when me and Fiona started talking about what could we do on the CPAs program. The obvious thing was all around this business case for, for valuation and for sustainability and now moving on and we'll discuss it later in the podcast, really looking at the underlying financial valuations as well.

## Host

*How are you both seeing investors and companies incorporate sustainability into valuation approaches?*

## Fiona Watson

Yeah. So Simon said he's an accountant, I'm actually coming to this agenda as a former lawyer. And I think that also brings different perspectives into this as you see how companies and investors are approaching this and it is multi-disciplinary. So you see particularly in the current context, a frankly very patchy approach, very patchy within corporates and is very patchy across the investor and the broader financial community. And I think that's where a number of reasons and we've collated a few examples in the work that we've done and will explore some of those reasons later on in the podcast. But there's the challenge with data, data availability, and there's a real lack of understanding as to consist of ways of doing this and the absence of that consistency and the absence of comparability is one of the challenges that we face. So that having been said, we've seen some really good examples of analysts in the external investor community leaning into this so we're beginning to see more and more high quality analysis on how this might come through, but we're really still lacking that kind of consistency in approach, which is, holding back a more systemic approach.

## Simon Weaver

And I'd agree with that, maybe just to build on a bit when I, when I was kind of reflecting on this before today's conversation, when I think back 5 to 10 years ago and, and sitting on and boards and audit committees, sustainability wasn't really discussed at all. Around the board table, it was if it was an event that happened that year and therefore they felt like they needed to talk about it. But as a result, in terms of how it is taken into financial valuation approaches, it was really only if something had happened recently that therefore is in their business plan for the next 1 to 3 years. I think a lot has changed over the last five years, and a big part of that is due to things like the TCFD, the taskforce for climate related financial Disclosures and now the ISSB as well. Taking that on. Really challenging boards to think about what are those climate and sustainability related financial risks and opportunities. And I think that that financial component of what those frameworks ask for has, has really changed the conversation in the boardroom and therefore the conversation around this topic of financial evaluation. But to completely agree with what Fiona said, even though we now understand there are these financial risks, opportunities, the challenges, how do you now embed those into financial valuations themselves? And back to the piece of work we did with Fiona in the team on the business case for sustainability, without really understanding how to embed them into financial evaluations, proving that business cases is really tricky and that's why we've moved on to the sort of second phase of the project to really get to grips with that with that challenge.

## Host

*What factors influence decision makers when it comes to incorporating sustainability into valuation approaches?*

## Fiona Watson

Well a view of the data and the approach, and that it really does start with data. So with that, once you do have, you know, an understanding of your data sources, there are probably four key factors that we see influencing this type of decision making. The first will be around content. The first will be around context, exposure and position. So understanding a company's specific exposure to physical and transition risks. So for example on geography or the regulatory environment, market environment etc. as well as the strategic environment, competitive forces and their company positioning. The second probably value drivers. So identifying elements like supply, pricing, demand and organizational resilience that could really materially impact financial performance. The third of the four forecasts financials and accounting. So connecting sustainability risks and opportunities to revenue. So that translation which Simon talked about and which we're working on now is just so challenging. But that's that third factor. And then the final would be around model assumptions. So when direct line items are really hard to quantify you see a lot more estimation and assumptions coming in. So adjusted risk premiums, discount rates, terminal values and so on, which can really create meaningful influencers and how it's driven, but I think is also important to note that the going back to the first point, the context is really important, and investors will use very different metrics depending on their own strategy. So, we sometimes talk about investors as this homogeneous community of single-minded professionals, which they're obviously not. They're all diverse in their strategies and their areas of emphasis. And so even though there'll be these large sets of ESG data, a lot only rely on the metrics that are most material to their approach, which in turn can make it harder for corporate teams and boards to really anticipate and understand where those material drivers are going to be. And some indeed don't materialize until after the fact. So that forward looking view can often be challenged by reality.

## Simon Weaver

And I'd agree. And I think the I mean, just to pick up on the value drivers point, that's something that we're really, really focused at, at KPMG at the moment, because when we look at all of the different disciplines across KPMG, understanding that and how sustainability plays into those value drivers is, is so, so important in terms of advising clients, maybe just to build on what Fiona said and in a way this is thinking about why maybe is it not being embedded into financial valuations as much as we'd like it to be? And the first one is the kind of inherent short termism of, of most businesses. And so if you take the value drive, for example, if when you overlay sustainability into those value driver trees, what you're looking at is something that doesn't impact that organization until, say, year four or year five, that often can just sort of disappear when you get to the financial valuations. And that's clearly for anybody in the know of, of what we're facing into from the climate crisis and broader sustainability issues. That's just not, feasible

in terms of an approach, to get to the answers that we need to get to. If we keep looking into that short term view, then ultimately it's going to be too late before we make the changes that we need to. And that, for me, is why this is so important. One thing that's interesting on this sort of short termism point is conversations having with chief sustainability officers, head of sustainability. At the moment, there's a lot more focus on adaptation, and the reason for that to be totally blunt is because they're seeing it in the short term, and it's impacting their businesses today, and therefore those physical impacts and, and, and resilience issues will start to get factored in. All being factored into to financial valuations. But it's really important that we're talking about adaptation and mitigation. Otherwise we'll be talking about a lot more adaptation in the years to come. So one of the things we really need to focus on is how do we get those mitigation components into the financial valuations as well. So I think that's the kind of short termism component. And the other factor is probably just the huge complexity and level of uncertainty that we're trying to deal with when it comes to these, these valuations. And maybe we'll come onto that in a bit more detail in the next, the next section.

### **Fiona Watson**

Just picking up on that. The physical risk has become such a hot topic over the last 18 to 24 months, over a number of reasons. I think it's, as you see, moving from the slightly conceptual concept of climate into a broader environmental context. And people actually see and are experiencing those changes in real time. And then the beginning businesses and regulators are beginning to observe those impacts. So you are starting to also get better data, but you're getting better momentum around understanding and receptiveness of that. We're now seeing that insured claims related to extreme weather events have exceeded \$100 billion for five years in a row, so we're beginning to see systemic data points come through that helped to drive that valuation and action. But I think around that we talk about uncertainty in a minute. There is very limited visibility on what the value at risk actually is there. And with that comes an anxiety which starts to play into investor behaviour and broader financial pricing, which just compounds the uncertainty and the volatility the corporates and investors are dealing with.

### **Host**

*What challenges are you seeing investors and companies face and what does all this mean at a national government level?*

### **Simon Weaver**

So I think in terms of the challenges and we've touched on the fuel already in in the earlier questions, but I think the biggest challenge for me is, is this point around complexity. And it is it's really hard. Before I as an account that's I'm a I was a mathematician and for me a big part of this is just a mathematical issue. But it's really, really complex. I often talk about a sort of comparability to pensions accounting. A chief sustainability officer said to me once that the big problem here, Simon, is that accountants can't deal with uncertainty. They hate uncertainty, but scientists and

economists love it. And somehow we've got to get over that barrier. I was also recommended yesterday a book and, and one thing that came up, which I thought was really relevant for this conversation, is one of the concepts that was discussed in the book is that the economy equals accounting plus behaviour. And what it means by that is, if you think of the economy as schematically as an interaction of accounting and human decision making, accounting is represented by the network of balance sheets and whether they're explicit or implicit for households, corporates and governments across the world. But ultimately, those balance sheets are continually changed based on human behaviour. And when we think about how we respond to the climate crisis and broader sustainability issues, ultimately a lot of it is down to that huge behavioural change program, which is one of the biggest challenges we as business, but also along with all of the other stakeholders, are having to deal with in terms of how we respond to to all of that, both in terms of not damaging economic growth, but also ensuring the prosperity of our societies while we also try and move to a low carbon society. And that equation for me, really kind of to some of the conversation we had earlier thinking about that, the accounting component of it, how do we make sure that we're getting that right? So really, we can start to show the economic benefits and of some of the actions that ultimately corporates want to do, but often they're struggling to prove their business case.

### **Fiona Watson**

So I think hearing Simon talk about complexity, I could complement that with a view that one of the challenges around uncertainty because and a question of how good is good enough as we try to understand these approaches and methodologies. Now, what is good enough to understand that we're leaning into an existential risk and that's going to affect corporate valuation. So that's testing our system is testing the system that's evolved and served this some of us very well in recent periods of economic history. It really is testing what corporations have for what they're here for, what their role is, and the rules that are used to measure and account for their performance. And we do need new accountability frameworks for that. We do need a better understanding of particularly scientific data. So the Greenhouse Gas protocol has been an example of that. And then there's work now on nature metrics and circularity metrics and so on. So that's adding to the complexity that Simon doesn't like. But it's also adding to the uncertainty which I see. So there's a lot of complexity and a lot of uncertainty in particular, as we really try to drive a closer nexus between the economy and the science, because that's one of the things that's been missing. Businesses have operated as these hypothetical legal structures with hypothetical hybrid rules around financial accounting. But now we need to operate and put that in the context of the physical environment that we're in. So there's complexity, there's uncertainty. And the markets don't like that. So they don't like volatility. And obviously all this is playing out against the backdrop of an unprecedented geopolitical environment, which adds to that. So this this this issue, this challenge is by no means in isolation of broader challenges. And that's adding to the challenges around the

level of conviction that boards need to allocate capital, the degree of mandate that they need from their investors and their broader stakeholders to make that and stick to what is currently a longer term view. So it is a challenging environment, but it's also a great opportunity for the type of collective thinking, and collaboration that we're delighted to do with, with KPMG and the broader members at WBCSD.

### **Simon Weaver**

And maybe just to pick up on that point of uncertainty and to the second part of the question around, and what does that mean at a national government level? A big part of the uncertainty comes from companies not really knowing what governments are going to do and where those policies are going to come from. And one of the things that we talked about a lot at COP29 and continuing through this year and all up to COP 30 in Brazil is around the need for much better, or at least some country level transition plans. And for me, until we have those and they don't need to be perfect, they can't be perfect. Just like for corporate transition plans, there's going to be some uncertainty in there and some assumptions. But once countries start to set that out, that's something that corporates can plug into. And I think that's something that absolutely needs to happen at that national government level. The second thing, at the national government level, to sort of build on, on Fiona's last point as well, is around collaboration. This is a systemic issue is, as Fiona said, and ultimately, therefore, the way that we solve it needs to be systemic and therefore needs to be collaborative. And I think there are, you know, there's some great examples of of industry groups and cross-industry groups and different initiatives that have got together. But I think there is more we could do at a national level to bring people together and incentivize more collaboration rather than potentially disincentivize.

### **Fiona Watson**

And doing that across value chains, because there have also been quite significant sectors of the value chain that haven't necessarily communicated on the systemic risk in the way they would. So I spent ten years in in banking, in the prudential environment. It's critical. So we've seen great work and great thinking from the Financial Stability Board and the NGO office, the network for Greening the Financial System, working on some of the models that they see is relevant for this from as a central banking perspective. But those are still a long way from the real economy and driving better connectivity so that we're able to take a systemic view is going to be really helpful. So that collaboration at all levels, government level, inter-government level, and then within and across value chains is going to be critical.

### **Host**

*What are you and others trying to do to change or support those dealing with these challenges? Simon, can I come to you first?*

### **Simon Weaver**

So I think back to a couple of things I talked about a moment ago, in terms of one, trying to bring there or bridge the accountant's view of the world, and then the, the scientists

and the economists, and then also thinking about that equation in terms of how important accountancy is and getting that right within the in the economy. We at KPMG see that one area that we can really make a difference is in that accounting aspect. And how do we really embed sustainability risk and opportunities into financial valuations? We recognize that's not something we can do alone, and that's why, it was actually at COP 29. And we've been having some conversations before Fiona and I discussed — Well this is something that back to that collaboration across value chains. We needed to convene across the professional services sector to really bring the right brains into the room to, to understand how do we crack that challenge. And that's what we've been we've had a sort of kick-off session a couple of months ago, and we've got what we call an ignition session in a few days time, where we're bringing the best minds from both the professional services world, but then really importantly, from the academic world, from investors, from NGOs, to really think about how do we how do we solve this, but also solve it in a way that's pragmatic and practical to deliver on? I think far too often when we look back over the last few years, we've come up with perfect solutions, whether there's regulatory, reporting or otherwise, that ultimately, practical enough for corporates to, to deliver on. And that has resulted incorporates often leaning out of the challenges that we're facing into. So we're looking at how do we come up with a practical, pragmatic way to ultimately where we started on this podcast, build that business case for sustainability action across the corporate world?

### **Fiona Watson**

I think picking up on the way that Simon describes the need for that multi-disciplinary, engagement across different areas of expertise. We also see the need to mobilize that kind of cross-disciplinary and cross-functional engagement across corporates as well. So just this just requires different ways of working and being very open to understanding how others work. And because it does require new ways of doing things, new approaches, and the only way that we can accelerate our understanding of what that's going to requires is through that developing those new ways of working, being cross-disciplinary and in our approach.

### **Host**

*If a company and or investor is looking to incorporate sustainability into valuation approaches, what should they consider and where should they start? Any insights you can share from the WBCSD's, Corporate Performance and Accountability program?*

### **Simon Weaver**

So I think that for me, the first step is, is performing what we call a sustainability materiality assessment. So really understanding for your business what is material. And importantly, what's financially material. For, for you as an organization for your investors and, and broader stakeholders once you've started to identify those. So, they may be in, i it from a climate change perspective, or it may be much more on the social angle, depending on the sector that you're in identifying. And my advice is really then

identify the most material one. So choose 1 or 2. Look at what are the key metrics that really demonstrate how you take those forward. And you try and look at how would we embed those metrics into our business planning, because that's ultimately how we need to get it into financial valuations is by embedding it into business planning, into the forward cash flows that businesses are dealing with on a day-to-day basis. So they're probably the first two steps. And what we just talked about in terms of how the work we're doing across the profession and beyond is really then starting to systemize that. So not every company is having to do their own thinking. It will be something that has much more of a global approach and that we can all get behind.

### **Fiona Watson**

And I'd complement that by talking more about the internal engagement perspective. So as you do that analysis and as you do that work, make sure you're bringing your business teams in, bring your risk teams in, bring your lawyers in early and obviously your finance teams in because they will have the collective expertise to understand this. So top down board level supervision is critical. Executive level mandate and mobilization is critical. But it's critical in so insofar as it can create that real cross enterprise engagement to support the type of activities that Simon's talking about, it needs to be enterprise wide. It will not work if you provide a small team with a small budget to do the impossible.

### **Host**

*If you could give one piece of advice on this topic to our listeners, what would it be? Fiona, can I come to you first and then perhaps we can hear from Simon?*

### **Fiona Watson**

Well, on a on an individual level, it would be to listen and learn from each others and from others across the system. For companies that would really be picking up on what I was talking about earlier, really thinking differently about doing things, taking, challenging yourselves to take innovative approaches to this challenge, bringing people together who

might not ordinarily have worked together, but with a view, a clear objective as to what you want to achieve for investors. I think particularly now, I work a lot with corporates who did urge them to think about how they're engaging with corporates and how much engagement is leading to the types of incomes they want. Because there's a huge amount of cross-functional across stakeholder engagement that can be done there to really bring the C-suite with them. We see quite a few investors coming in, asking questions and quite a detached way, whereas it be a real opportunity for dialog to help executive teams understand what's really expected of them, so they can turn that into a mandate and help mobilize across the organization.

### **Simon Weaver**

Don't stop learning and listening as well, because I think sustainability is the topic where there's a very good reason. You've got two ears and one mouth. Too often people have a lot to say on this topic, but actually it's all about listening to those around you. Personally, I learn an awful lot nearly every half an hour in every conversation I have on this topic, and I think we can all do that a lot more. If I'm allowed to say one other thing, it would be embrace the complexity. Back to where I was on the challenges. This issue is far too big a problem that we can lean out just because it's complex.

### **Host**

*Simon and Fiona thank you. It sounds like many opportunities and challenges remain when it comes to incorporating sustainability into valuation approaches. Thank you so much for covering this topic for our audience, and for the work that you are doing on this systemic issue and I am sure it is a topic we will come back to as the conversation and initiative develops.*

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