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Environmental, Social, and Governance (ESG) Models for Private Foundations

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With the ever-increasing focus on an organization's impact and overall performance – be it within a commercial or philanthropic environment – Environmental, Social, and Governance (ESG) models have become one of the foremost ways to assess an organization beyond the existing traditional reporting frameworks.

As leaders of change and impact in the philanthropic environment, private foundations have an acute interest in understanding and establishing ESG models. In this article we aim to provide some of the more relevant considerations for private foundations with respect to ESG models, as well as some of the driving factors of ESG adoption.

Risk Assessment

Foundations are facing a growing demand from numerous stakeholders for transparency and introspection on their overall impact. These stakeholders can be both internal and external. Measurement of the foundation's ESG performance can seem daunting and unclear; however, it's important to remember that not all foundations are the same. Considering ESG model adoption should start from a practical perspective, the most practical way would be to perform a risk assessment of the foundation's stakeholders.

To start, a risk assessment of an ESG model might include an analysis or survey of the following major stakeholders of the foundation:

- Investments and Investment Managers
- Grantmaking
- Human Capital and Personnel
- Vendors and Contractors
- Regulators and Third-party Users
- Board of Directors

The objective of the risk assessment is to ascertain any major threats or impediments to the foundation's goal of maximizing its impact with each stakeholder.

Operational Practices and Execution

Following the completion of the foundation's ESG risk assessment, and subsequently assessing the results, the foundation should consider formalizing its ESG model to ensure the stated objectives are codified and operational in the form of policies and procedures.

Using the examples of major stakeholders defined in the foundation's risk assessment, a summarized version of some policies and procedures adopted might look like the following:

Investments and Investment Managers – The foundation's investment portfolio, to the extent possible, should consider selecting investment management firms aligned with the values established in the foundation's ESG model. Regarding the selection of prospective investments, the foundation should consider directing its investment manager to adhere to a socially responsible investment allocation plan, considering the prospective investment's non-financial sustainability factors such as carbon emissions, air pollution, green energy initiatives, waste management and water usage. In addition, consideration will be made to divest from certain investments that do not align with the foundation's adopted ESG model.

Grantmaking – The foundation's grantmaking due diligence policy should be updated to include pre-grant inquiries on the prospective grantee's alignment with the foundation's adopted ESG model. In addition, should the foundation determine it necessary, conditions imposed on the grant award should be monitored periodically for compliance. Such conditions might include tranched grant payments, specific reporting requirements, interim site visits, etc.

Human Capital and Personnel – The foundation should continuously assess the results of its risk assessment and survey to ensure the human capital and personnel align with the stated impact goals of the foundation. An appropriate policy would likely speak to establishing a Diversity, Equity and Inclusion (DEI) Committee, and appointing a DEI manager within the foundation.

Vendors and Contractors – The foundation should periodically assess the viability of its vendors and contractors with respect to its ESG model. Regular monitoring procedures to ascertain the vendor's compliance with the foundation's ESG model should be performed. The foundation might consider obtaining information on the vendor's human capital and personnel resources to verify alignment with the foundation's ESG model.

Regulators and Third-party Users – The foundation should establish policies that consider the likelihood of deviations from compliance with ESG requirements imposed by regulators or other external parties, particularly when making assertions in external financial reporting.

Board of Directors – The foundation's Board of Directors should consider establishing a subcommittee to govern the foundation's ESG initiatives. Oversight duties of the subcommittee should include monitoring of the foundation's compliance with the stated objectives of its ESG model, and report to the Board as a whole.

Reporting

While there is no generally accepted reporting framework for ESG, the importance of presenting financial and qualitative information in the foundation's annual financial statements has been increasingly more important to foundations, their grantees, and external parties. The primary considerations for foundations that wish to include financial and qualitative information in their external financial reporting should be to ensure the financial statements are presented in accordance with generally accepted accounting principles (GAAP). While GAAP defines the minimum standard for presenting financial statements externally, below you'll find a number of considerations the foundation might incorporate to expand and enhance its disclosures on ESG reporting within its financial statements and note disclosures:

- Notes to Financial Statements regarding the foundation and its tax status – typically, Note 1 to the financial statements – consider describing the foundation and its ESG model. However, when including the description of the ESG model, the most important factor is determining how this information is verifiable and supported in annually audited financial statements.

- An opportunity may exist in the foundation's reporting of net assets classifications – i.e., net assets without donor restrictions could include multiple sub-grouped classes, including Board-designated and/or ESG-designated funds.

- An opportunity for reporting ESG-related impact may exist in the Statement of Functional Expenses – particularly under the program services function – as the majority of grantmaking is classified within the program services function. In addition, consider the reasonableness of classifying internal and/or indirect management and general related expenses within the foundation's ESG model.

- Endowment disclosures regarding investable financial assets – an opportunity exists to describe more specifically the designations of invested endowment assets and the purpose and strategy of the foundation's various endowment funds.

- Supplementary Information provides the most leeway for reporting of underlying financial information the foundation wishes to disclose.

On the Horizon

Adoption of ESG models, including the reporting of ESG performance, is largely an unclear and undefined space at this point in time. Without a framework established by an entity governing ESG reporting requirements, there is no reference for foundation Board members and managers to seek guidance in their efforts to adopt a model suitable – and practical – for their foundation. However, the consensus is clear that uniformity in ESG models will likely be coming into the fold sooner than later, and the importance of adoption should not be overlooked.

Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other accounting, audit, tax or advisory matters relative to private foundations. Please call 212.286.2600 or email any of the Private Foundation Services team members below:

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