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Enhancing Trust in ESG Disclosures

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Significant progress has been made in corporate reporting of environmental, social, and governance (ESG) information, as evidenced by the rise in the number of S&P 500 companies that publish some form of a sustainability disclosure. At the same time, institutional investors, asset managers, lenders, credit raters, and insurers are increasingly relying on companies' ESG disclosures to make important decisions regarding the allocation of capital. Against this backdrop, there continues to be a growing call for companies to enhance the quality, comparability, and usefulness of their ESG disclosures.

In 2019, 90% of S&P 500 companies published sustainability reports.

A number of factors are driving this call to action:

- ESG investing continues to accelerate at breakneck speed. For example, UBS saw more than $71 billion of flows to ESG funds and pandemic bonds in the second quarter, bringing its ESG assets under management to $1 trillion for the first time. In addition, "[a] new record was set in 2019 for the volume of sustainable debt issued globally in any one year, with the total hitting $465 billion globally, up a remarkable 78% from $261.4 billion in 2018."
- According to the Harvard Law School Forum on Corporate Governance, the role that sustainability and nontraditional metrics play in investment decision-making is growing. "Investors are seeking [quantitative ESG] metrics to evaluate a company's approach to sustainability and its drivers of long-term growth."
- Although investors are increasingly relying on ESG disclosures, they remain dissatisfied with the level of appropriate quantitative ESG information, lack of comparability over time, and questionable data quality. In 2019, only 29 percent of S&P reporting companies obtained external assurance on their sustainability information.

What Is ESG Investing?

ESG investing involves incorporating nonfinancial factors related to the environmental impact, social impact, and governance attributes of a corporation into the evaluation of companies and affects the allocation of capital.

"People may choose not to invest in a firm that has poor ESG, thereby limiting its access to capital and raising its cost of capital."[1]

The lack of standardized investor-grade information in ESG reporting has become a sticking point among issuers, investors, and standard setters. It is clear that institutional investment decision makers and other capital market participants need standardized and increasingly quantitative ESG disclosures that are assured and can be used by investors to efficiently evaluate ESG information and integrate it into their decision-making process.

What Is ESG Reporting?

According to the CAQ, "ESG reporting encompasses both qualitative discussions of topics as well as quantitative metrics used to measure a company's performance against ESG risks, opportunities, and related strategies:"

- "The E, or **environmental**, component of ESG information encompasses how a company is exposed to and manages risks and opportunities related to climate, natural resource scarcity, pollution, waste, and other environmental factors. "
- "The S, or **social**, component of ESG includes information about the company's values and business relationships. For example, social topics include labor and supply-chain standards, employee health and safety, product quality and safety, privacy and data security, and diversity and inclusion policies and efforts."
- "The G, or **governance**, component of ESG incorporates information about a company's corporate governance. This could include information on the structure and diversity of the board of directors; executive compensation; critical event responsiveness; corporate resiliency; and policies on lobbying, political contributions, and bribery and corruption."

This *Heads Up* discusses multiple ESG market developments and steps that companies can take to enhance the quality of their ESG reporting.

ESG Information for Investment Decisions — Market Developments

U.S. Department of Labor Proposed Rule Related to ESG Factors in the Selection of Plan Investments

A Calvert report notes that "the most effective way to achieve the pecuniary benefits of improved risk/returns is to **support ongoing improvements in the quality of information available to investors**, not discouraging fiduciaries from considering them in the first place."

Institutional investors and asset managers are calling for enhancements in the quality and comparability of ESG disclosures, and regulators in leading markets around the world are moving forward with requirements under which investment fiduciaries must consider ESG factors. Meanwhile, the U.S. Department of Labor's Employee Benefits Security Administration issued a proposed rule on June 30, 2020, that would steer policy in the opposite direction by changing the "investment duties" regulation under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), as amended, to confirm that ERISA requires plan fiduciaries to select investments and investment courses of action solely on the basis of financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action. This action would represent a dramatic shift in the momentum across the globe and to current practices that asset managers and financial advisers use to integrate ESG considerations into their investment processes and selections.

There were 8,737 responses to the proposed rule during the 30-day comment period, and more than 95 percent of those comments opposed it. Some of the more common points raised included concerns that the proposed rule ignores the material financial impacts of ESG issues and is based on a flawed and unsupported assumption that ESG funds give up financial returns in favor of "nonpecuniary" rewards.

[1] ESG Matters (Harvard Law School Forum on Corporate Governance).

Other Market Developments

Many companies already disclose human capital measures in stand-alone ESG reporting under the GRI and SASB standards. We recommend that in determining how to leverage existing ESG human capital management disclosures to comply with the **SEC's Regulation S-K requirements**, companies use a financial materiality lens, use a recognized ESG standard, and subject such disclosures to appropriate disclosure controls and procedures.

Other developments are demonstrating the clear and compelling call to action by the marketplace for companies to disclose certain ESG information in mainstream financial filings as well as strong support for standardization and enhancement of the quality of ESG disclosures, including strengthened requirements related to assurance over that information. Some of these developments are summarized below:

- On August 26, 2020, the SEC issued a final rule that modernizes certain disclosure requirements in Regulation S-K.[2] Two SEC commissioners, Caroline Crenshaw and Allison Herren Lee, dissented to the decision and expressed concern that the final rule does not go far enough to adequately address climate change risk, human capital, and diversity. Commissioner Lee stated, "It's time for the SEC to lead a discussion — to bring all interested parties to the table and begin to work through how to get investors the standardized, consistent, reliable, and comparable ESG disclosures they need to protect their investments and allocate capital toward a sustainable economy."
- Other SEC activity:
  - The SEC's Investor Advisory Committee published a report encouraging the SEC to develop a framework for ESG reporting in SEC filings.
  - The SEC's ESG Subcommittee provided a report in May 2020 and an updated report in September 2020 to the SEC Asset Management Advisory Committee highlighting the need for certain ESG-related disclosures by asset managers including disclosure and independent validation of the degree of ESG compliance.[3] The report also noted that the ESG subcommittee is studying possible enhancements to issuer disclosures.
- The International Business Council (IBC) of the World Economic Forum (WEF) published a report that includes a set of core ESG metrics designed to enable companies to measure and report on sustainable value creation. Facilitated by the Big Four accounting firms, the publication helps advance the momentum toward global ESG standards by establishing a coherent and comprehensive corporate reporting system. The WEF-IBC report includes references to the separate WEF, Impact Management Project, and Deloitte's facilitated efforts to align global standards and frameworks, which culminated in the issuance of a joint statement by the five major ESG standard-setting institutions of a shared vision of what is needed for progress toward comprehensive corporate reporting and their intent to work together to achieve it. At the same time, the International Federation of Accountants launched its consultation for the IFRS Foundation to create an authoritative nonfinancial standard setter.
- The Commodity Futures Trading Commission, an independent U.S. federal agency, issued a report calling for regulators to actively promote, and in some cases require, better understanding, quantification, disclosure, and management of climate-related risks.
- The Financial Accounting Foundation sent a survey asking the public about what the group's future priorities should be, including whether it should explore nonfinancial accounting standards such as those related to ESG issues.
- Large investors, including CalPERS (the largest U.S. public pension fund), are calling for mandatory reporting by companies and auditors on climate risk.
- Asset managers continue to focus on ESG within investment decisions. BlackRock published a special report highlighting its increased engagement on ESG and actions taken against companies deemed to be making insufficient progress. State Street issued a letter to board chairs requesting that companies provide

[2] See Deloitte's September 3, 2020, *Heads Up*, for more information about the final rule.
[3] See also Drumbeat Grows Louder for SEC to Take Action on ESG Disclosures (Latham & Watkins LLP).

enhanced disclosure about diversity, specifically racial and ethnic diversity, including communication related to strategy, goals, metrics, the board, and board oversight.

- The European Commission's upcoming revisions to the European Union Non-Financial Reporting Directive, which, on the basis of consultation responses received, could expand the scope of the directive to more companies and could require companies to provide additional disclosures of (and assurance over) ESG matters in annual reports.

A 2017 CFA Institute survey notes that 69% of portfolio managers and research analysts think it is important that ESG disclosures be subject to independent verification.

As these actions indicate, ESG disclosures are critical to institutional investment decision makers and other capital market participants. The section below explores how the quality of ESG disclosures can be improved and how assurance over ESG information is an effective means of enhancing such quality and trust.

Improving the Quality of ESG Disclosures

The manner in which investors are analyzing a company's ESG disclosures is similar to how they assess financial information because performance on ESG metrics can affect financial performance. Evaluating ESG information at the onset of a potential investment can help investors better determine and understand the investees' governance and short- and long-term strategies related to addressing material risks and opportunities. Once an investment is made, investors use ESG information to monitor performance, much in the same way they use financial information. However, the critical element of the financial reporting process that is still largely missing and needs to be institutionalized in ESG reporting is external assurance.

Sustainability Assurance as a Tool to Enhance ESG Disclosure Governance and Quality Reporting

"One of the key differentiators is the fact that CPAs perform assurance engagements in accordance with AICPA professional standards which require them, among other things, to be independent, to maintain a system of quality control and to ensure that their engagement teams have the appropriate competence and capabilities."[4]

Improving the quality and consistency of ESG disclosures will enhance transparency, which will enable and enhance investing decisions and potentially reward more sustainable businesses and strategies by unlocking capital. Using a recognized standard for disclosure of ESG information and obtaining sustainability assurance are key steps toward improving the quality and consistency of ESG reporting. The AICPA and the Global Reporting Initiative (GRI) published FAQs in response to an increasing number of inquiries related to sustainability assurance. The FAQs explain that assurance on ESG information is designed to enhance the degree of confidence of decision makers that use that information. The FAQs also address why organizations choose to have their sustainability information assured. For example:

> [O]rganizations determine that the reporting of sustainability information may not be enough, and decision-makers desire further confidence in its reliability. Assurance can increase the confidence of decision-makers in the accuracy and reliability of the reported information.
>
> It can also support organizations in:
>
> - signaling to their stakeholders the importance the organization places on sustainability reporting,
> - strengthening internal controls and reporting systems relating to sustainability reporting,
> - raising awareness of the importance of sustainability information at Board and C-suite level, and
> - driving better decision-making based on higher quality sustainability information.

Furthermore, the Sustainability Accounting Standards Board's (SASB's) Implementation Primer ("a reference document for companies that have chosen to integrate SASB standards into their core communications with investors") indicates that assurance is a signal that the information is reliable. The Implementation Primer also illustrates how external assurance provides internal benefits for companies, including enhancing a company's rigor and internal quality control processes that pertain to measuring and disclosing ESG information.

[4] AICPA Teams With GRI, SASB on Sustainability Assurance (*Accounting Today*).

Practical Considerations for the Board and Management Related to Integrating ESG Into the Business and Preparing High-Quality ESG Disclosures

The ESG integration maturity model below shows the stages of ESG maturity and describes common attributes associated with those stages.



Stages of ESG Maturity	Common Attributes Associated With Stages of ESG Maturity
Integrated ***Value enhancing*** through established governance, risk management, strategic allocation of resources, data management processes, controls, reporting, and assurance	• Established board oversight with defined committee charters, regular updates, and training • ESG integrated into management roles and responsibilities, including executive compensation • ESG risks integrated into enterprise risk management in a manner similar to other business risks • ESG integrated into the internal audit plan • ESG reporting in accordance with leading standards • Reasonable assurance by the financial statement auditor
Enhanced ***Performance driven*** to enhance internal controls, ESG data collection, and performance management	• Board and executives receive annual update • Cross-functional ESG committee oversees sustainability priorities and performance • Stand-alone sustainability strategies • Formal ESG materiality determination process and steps taken to integrate ESG into enterprise risk management • ESG reporting aligned to or guided by standards • Limited assurance
Responsive ***Compliance driven*** to respond to ESG requirements and changing expectations	• Limited board oversight • ESG responsibility resides outside of established management systems and controls and with one or a few parts of the organization (e.g., compliance, marketing) • ESG considerations are not integrated into the business and are regulatory and compliance driven • Limited ESG reporting with no reference to standards • No assurance

As companies navigate societal and environmental trends and changing stakeholder expectations, they need to establish a systematic approach to sensing rapidly changing disruptors that affect external reporting. Actions management can take now in connection with providing ESG information that is more standardized and reliable are illustrated in the graphic below.

ESG Integration and Disclosure Strategy — Key Steps



Conclusion

Growth in public and investor demands for ESG accountability is compelling companies to pay closer attention to expectations and enhancements related to sustainability disclosures. Developing a robust governance structure, integrating internal audit and the board of directors into such structure, and obtaining external assurance (i.e., the three lines of defense) can enhance public trust and improve a company's ability to meet investors' and other stakeholders' expectations related to the disclosure of accurate and reliable information. It may also reduce risks related to misleading or omitted disclosures. Implementing the three lines of defense will promote high-quality, relevant, and meaningful nonfinancial disclosures, enhance investors' reliance on reported information, permit better analysis of such information, and promote ESG investing.

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