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Sustainability Reporting: Time to Get Serious?

In a prior issue of *The Bulletin*, Protiviti discussed the evolution of sustainability; why reporting on environmental, social and governance (ESG) criteria is important; the obstacles to ESG initiatives; the ESG maturity continuum; what companies should be doing to tackle this topic; and examples of sustainability leaders.[1] The premise underlying a corporate focus on sustainability is that corporate leadership is needed to enhance civilization's ability to address critical environmental, economic and social challenges and enable the general welfare of present and future generations. Moving beyond theory, ESG criteria offer powerful differentiators for screening investments — a reality that cannot be ignored in the boardroom and C-suite.

In this issue of *The Bulletin*, we discuss sustainability reporting — what it is, how it is being enabled, why it is important, and market developments to watch. Every public organization needs to be mindful of the growing interest in sustainability and reliable, comparable reports.

WHAT IS SUSTAINABILITY REPORTING?

Organizations publish sustainability reports to disclose the economic, environmental and social impacts caused by the everyday activities of their businesses. These reports describe an organization's values and governance model and evidence the extent to which the company's strategy and commitment to a sustainable global economy are linked. ESG reports provide transparency and accountability to investors, regulators and other stakeholders and help drive improvement of internal processes and market offerings.

[1] "Sustainability: The What, Why and How," Protiviti, *The Bulletin*, Volume 6, Issue 11, May 2018, available at www.protiviti.com/US-en/insights/bulletin-vol6-issue11.

While many companies often see this form of reporting as an exercise to meet stakeholder expectations, most realize that strong sustainability performance conveys the potential for more sustainable revenue streams, higher customer and employee retention, and reduced regulatory risk. Plus, it's the right thing to do.

The discipline of sustainability reporting can help organizations measure and monitor performance against established economic, environmental, social and governance goals. The increased transparency leads to better decision-making and a sharper focus on communicating with external stakeholders, as well as advancing the maturity of the organization's capabilities in addressing ESG objectives. Many institutional investors have come to expect sustainability reports as a source of information to be incorporated into their investment analysis. Importantly, reporting companies gain the most from sustainability reports when they use them as a means of understanding, communicating and improving organizational performance rather than merely producing a report as an end in itself.

ALTERNATIVE FRAMEWORKS AND THE ROLE OF THE SASB

There are various sustainability reporting guidance materials available in the marketplace. Examples of such frameworks include:

- The Global Reporting Initiative (GRI), the official reporting standard of the United Nations (U.N.) Global Compact, places equal weight on ESG factors. It is applied to public and private companies, not-for-profits, and public sector entities.
- Dow Jones Sustainability Indices (DJSI), perhaps the longest-running global sustainability benchmarks worldwide, are based on an analysis of corporate economic, environmental and social performance, assessing issues such as corporate governance, risk management, branding, climate change mitigation, supply chain standards and labor practices. DJSI are applied to some of the largest public companies in the world.
- The GRESB is an investor-driven organization committed to assessing the ESG performance of real estate assets globally. Its assessment is applied to commercial real estate owners, asset managers and developers.
- The Sustainability Accounting Standards Board (SASB) develops standards for reporting sustainability performance by industry — which, accordingly, vary by industry — enabling investors and companies to compare performance from company to company. It targets public companies in the United States for integration into their Form 10-K reports.

Sustainability reporting guidance varies significantly, so consistency across the globe remains an elusive objective.

The above examples are intended to illustrate the multiple frameworks in use and are not intended to be an exhaustive list. The key point is that sustainability reporting guidance varies significantly, so consistency across the globe remains an elusive objective. Since the SASB is relatively new to this domain and is directing its focus on the United States, which lags the European Union (EU) in sustainability reporting, we will discuss its approach further below.

The SASB's mission is to help businesses around the world identify, manage and report on the sustainability topics that matter most to investors. Standards are developed based on extensive feedback from companies, investors and other market participants as part of a transparent, publicly documented process. There are 77 industry-specific codified standards, launched in November 2018 at the London Stock Exchange. They outline the minimal set of financially material sustainability topics and their associated metrics for the typical company in a particular industry. The 77 industries are arrayed among 11 sectors.[2]

The SASB selects key topics by sector that are reasonably likely to affect the financial condition or operating performance of companies within the sector. These topics are based on several key principles evidencing investor interest and financial impact — industry relevance, value creation potential, actionable by companies, of interest to investors, and reflective of stakeholder consensus. The topics are designed to guide management's risk analysis, strategic analysis, and preparation of the management discussion and analysis (MD&A), risk factors and other relevant disclosures in public reports, as appropriate.

Some 26 general issue categories comprising a range of disclosure topics are grouped among five dimensions: environment, social capital, human capital, business model and innovation, and leadership and governance. The 26 issues are summarized below:

DIMENSION	ISSUE CATEGORY	
Environment	• Greenhouse gas (GHG) • Air quality • Energy management	• Water and wastewater management • Waste and hazardous materials management • Ecological impacts
Social Capital	• Human rights and community relations • Customer privacy • Data security • Access and affordability	• Product quality and safety • Customer welfare • Selling practices and product labeling
Human Capital	• Labor practices • Employee health and safety	• Employee engagement, diversity and inclusion
Business Model and Innovation	• Product design and life cycle management • Business model resilience • Supply chain management	• Materials sourcing and efficiency • Physical impacts of climate change
Leadership and Governance	• Business ethics • Competitive behavior • Management of legal and regulatory environment	• Critical incident risk management • Systemic risk management

[2] For more information, see the SASB website: www.sasb.org.

For each issue germane to a given industry, accounting metrics that vary by industry are provided. The SASB's Materiality Map®, available at https://materiality.sasb.org/, is an interactive tool that identifies and compares disclosure topics across different industries and sectors. For each industry-specific disclosure topic, the related standards provide appropriate accounting metrics and technical protocols for compiling relevant data. The SASB recognizes that normalizing performance data is important for the analysis of disclosures pursuant to its standards. Therefore, the industry standards contain activity metrics that are designed to assist in a reliable evaluation and comparability of reporting.

THE TREND TOWARD INTEGRATED REPORTING

With sustainability reporting proliferating across the planet, better alignment in corporate reporting standards is needed to make it easier for companies to prepare effective and coherent disclosures that meet the information needs of capital markets and society and foster comparability on a global basis. To that end, the SASB, GRI and International Integrated Reporting Council (IIRC) have announced a two-year project to collaborate on standardization of sustainability reporting frameworks, as well as on frameworks that promote further integration between nonfinancial and financial reporting.[3]

Given the emphasis by standard-setters, companies and their boards — specifically, the audit committee — should monitor the trend toward integrated reporting. Such reporting is likely to address the company's stewardship in deploying various forms of capital in the business: financial, manufactured, intellectual, reputational (social, cultural and community relationship), human and natural. The idea is for companies to tell their story in one integrated report (versus the fragmented approach of separate reports) to emphasize a broader range of measures underlying their commitment to sustainable development and ethical values in pursuing near- and long-term profitable growth. That trend reflects the continued emphasis on disclosing nonfinancial data to investors consistent with the notion that market capitalization is derived from sources of value beyond strong financial performance.

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As with ESG reporting, management's focus and the audit committee's oversight emphasis on integrated reports — if the company were to issue an ESG report — should be on the effectiveness of the related disclosure controls and procedures.

[3] "Leading Corporate Reporting Bodies Launch Two-Year Project for Better Alignment," Integrated Reporting (IR), November 7, 2018, http://integratedreporting.org/news/leading-corporate-reporting-bodies-launch-two-year-project-for-better-alignment/.

WHY IS SUSTAINABILITY REPORTING IMPORTANT?

A recent survey of more than 500 public company directors noted that although ESG issues are currently a relatively low priority for many boards, most directors would like their boards to become more proactive and enhance ESG oversight. Specifically, 53.6 percent of public company directors would like their board to improve its understanding of the company's current levels of ESG-related performance, and 49.8 percent would like to ensure ESG is strongly linked to the company's strategy. This growing interest is likely due to increased shareholder activism evidenced by high-profile proxy battles over ESG-related topics and institutional investors proactively assessing ESG performance of companies in their portfolios.[4]

The above research suggests that the CEO's level of interest is crucial to progress from passive interest to an action-oriented perspective about sustainability issues. There are many reasons sustainability reporting merits the attention of CEOs and their boards:

- **Responsible investing is emerging as a source of outperformance.** A recently released study by an asset management company noted that during the period from 2014 to 2017, responsible investing was generally a source of outperformance in both the eurozone and North America. In the eurozone, all ESG pillars and ESG score integration displayed positive returns, with the governance pillar dominating. In North America, ESG investing during this same period (2014 to 2017) also displayed positive returns, although the environmental component was the biggest winner. The study also noted that the massive mobilization of institutional investors regarding ESG investing in Europe has had an impact on demand mechanisms, with a consequent effect on prices, thereby triggering a performance premium.[5]
- **Providers of global governance services are integrating sustainability guidance.** Glass Lewis has integrated the SASB's guidance on material ESG topics into its proxy research reports and vote management application, Viewpoint.[6] Glass Lewis assists the majority of the world's largest pension funds, mutual funds and asset managers, which collectively manage more than US$35 trillion in assets.[7] Other similar organizations may be weighing similar steps.
- **Shareholder proposals on ESG matters and voting support are steadily increasing.** This development has been unfolding over the past several years, even though such proposals are still rarely approved. But the noise level continues to rise. Examples of issues that have commanded attention in recent proxy seasons include investigating the impact of climate change on the business, improving diversity in the boardroom, increasing efforts to fill existing gender pay gaps, and linking executive compensation to human capital management.[8]

[4] 2018-2019 NACD Public Company Governance Survey, National Association of Corporate Directors, December 2018, available to subscribers at www.nacdonline.org/analytics/survey.cfm?ItemNumber=63801.

[5] "The Alpha and Beta of ESG Investing," Amundi Asset Management, January 14, 2019: http://research-center.amundi.com/page/Article/2019/01/The-Alpha-and-Beta-of-ESG-investing.

[6] "Glass Lewis to Integrate SASB's Industry-Specific Materiality Guidance Across Research and Vote Management Products," Glass Lewis press release, September 12, 2018: www.glasslewis.com/glass-lewis-to-integrate-sasbs-industry-specific-materiality-guidance-across-research-and-vote-management-products/.

[7] See www.glasslewis.com/company-overview/.

[8] "Amid Increasing Demand for ESG Disclosure, Voting Support for Shareholder Resolutions on Environmental and Social Issues Is Rising," media release, The Conference Board, November 8, 2018: www.prnewswire.com/news-releases/amid-increasing-demand-for-esg-disclosure-voting-support-for-shareholder-resolutions-on-environmental-and-social-issues-is-rising-300746843.html.

- **Global organizations, governments and markets are concerned about climate change.** Two recent developments illustrate this concern.

  1. A report on climate change issued by a U.N. body for assessing the science related to climate change addressed the impact of global warming of 1.5 degrees Celsius above preindustrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty. It argued that companies and governments must act faster.[9]

  2. A U.S. government report also contained a warning on climate change. It projects the economy could lose hundreds of billions of dollars — or, in the worst-case scenario, more than 10 percent of its gross domestic product (GDP) — by the end of the century. It asserts that not a single G20 country is meeting its climate targets and, without significant reductions in greenhouse gas emissions, the annual average global temperature could increase 9 degrees Fahrenheit (5 degrees Celsius) or more by the end of this century, compared with preindustrial temperatures.[10]

Those reports and other research are likely to fuel further debate on climate change and harden the determination of activists to do something about it. Few companies will have the fortitude to display indifference to the issue, given the intensity of the debate and insistence on action by a swelling tide of influence.

- **Organizations are tying executive compensation to ESG metrics.** Over time more companies are linking compensation and sustainability progress. In 2014, Glass Lewis found that 40 percent of all global companies reviewed provided a link, up from 29 percent in 2010. Among U.S. companies, Ceres found the number of companies linking executive pay to sustainability grew from 15 percent in 2012 to 24 percent in 2014. The Corporate Knights' 12th annual Global 100 Most Sustainable Corporations list found that 87 percent of the Global 100 firms provided a monetary bonus to executives who achieved sustainability targets, up from 85 percent in the prior year.[11] Recently, Royal Dutch Shell committed to an energy industry first, announcing that executive compensation will be tied to short-term carbon emissions targets starting in 2020 to address the issue by cutting emissions generated by both its activities and the products it sells.[12]

> *Growing interest [in ESG performance] is likely due to increased shareholder activism evidenced by high-profile proxy battles over ESG-related topics and institutional investors proactively assessing ESG performance of companies in their portfolios.*

9 "Special Report: Global Warming of 1.5 °C," The Intergovernmental Panel on Climate Change, October 2018: www.ipcc.ch/sr15/.

10 "The Feds' 2,000-Page Prod for Sustainable Investing," by Crystal Kim, *Barron's*, November 30, 2018: www.barrons.com/articles/the-feds-2-000-page-prod-for-sustainable-investing-1543621815.

11 "Why Most Companies Don't Link ESG Performance to Executive Pay," by Jessica Lyons Hardcastle, *Environmental Leader*, January 29, 2016: www.environmentalleader.com/2016/01/why-most-companies-dont-link-esg-performance-to-executive-pay/.

12 "Shell Is First Energy Company to Link Executive Pay and Carbon Emissions," by Ivana Kottasová and Daniel Shane, CNN Business, December 3, 2018: www.cnn.com/2018/12/03/business/shell-climate-change-executive-pay/index.html.

- **Sustainable investing is on the rise.** Sustainable, responsible and impact investing assets have expanded to $12 trillion in the United States, up 38 percent from $8.7 trillion in 2016. Much of this growth is driven by asset managers considering ESG criteria across $11.6 trillion in assets, up 44 percent from $8.1 trillion in 2016. The top three issues for asset managers and their institutional investor clients are climate change and carbon emissions, tobacco investments/stocks, and conflict risk. From 2016 through the first half of 2018, 165 institutional investors and 54 investment managers controlling $1.8 trillion in assets under management filed or co-filed shareholder resolutions on ESG-related issues.[13]
- **Governments around the world require sustainability reporting.** The sustainability reporting rates are around 80 percent in the Americas, Europe and Asia-Pacific and 50 percent in the Middle East and Africa.[14] As global standards converge, comparability and transparency increase.

These market developments suggest it is inevitable that sustainability reporting will become a mainstay in the corporate environment, especially as investor support continues to strengthen.

MARKET DEVELOPMENTS TO WATCH

As professionally managed funds deploying the concept of selective investing using ESG criteria to screen investments have increased assets under management into the trillions of dollars and elevated their activism around ESG-related issues, directors and executives have taken notice.[15] Regulators are getting rulemaking petitions for standardized disclosures.[16] As a result, more companies are embracing sustainable development by making commitments on various ESG fronts. As they do so, they are finding it compelling, for a variety of reasons, to disclose their performance against ESG criteria to differentiate themselves from an investment-screening standpoint, particularly if major investors expect such reporting.

Management's commitment to sustainability places emphasis on actions, not words; on disruptive innovation, not "business as usual"; and, most important, on leadership, collaboration and transparency.

As more emphasis is placed on disclosure of ESG performance to the investment community, the audit committee should give greater attention to the disclosure controls and procedures that provide reasonable assurance that such disclosures are prepared and presented fairly.

[13] "Sustainable Investing Assets Reach $12 Trillion as Reported by the US SIF Foundation's Biennial Report on US Sustainable, Responsible and Impact Investing Trends," US|SIF: The Forum for Sustainable and Responsible Investment, October 31, 2018, see www.ussif.org/files/US%20SIF%20Trends%20Report%202018%20Release.pdf.

[14] "The Road Ahead: The KPMG Survey of Corporate Responsibility Reporting 2017," KPMG, 2017: https://assets.kpmg/content/dam/kpmg/xx/pdf/2017/10/kpmg-survey-of-corporate-responsibility-reporting-2017.pdf.

[15] "The Relevance of Sustainability Performance to Board Risk Oversight," *Board Perspectives: Risk Oversight*, Issue 103, Protiviti, May 2018: www.protiviti.com/US-en/insights/bpro103.

[16] Letter to Brent J. Fields, Secretary, SEC, October 1, 2018: www.sec.gov/rules/petitions/2018/petn4-730.pdf.

Following are eight key factors for interested companies to monitor going forward:

1. **Competitors issuing voluntary reports.** As more companies report voluntarily, peers will have to consider whether to follow suit. The SASB provides useful examples of companies reporting in accordance with its standards at www.sasb.org/company-use/ to illustrate the transparency and impact of such reports on risk management, long-term performance and brand image.

2. **Securities and Exchange Commission (SEC) mandates.** As noted above, the SEC has been petitioned to standardize and mandate ESG disclosures. However, to date the Commission has been content to let market forces determine what issuers report.

3. **Attestation of selected sustainability information is increasing.** In 2017, the American Institute of Certified Public Accountants (AICPA) issued attestation standards in response to increasing stakeholder expectations and more companies reporting on ESG performance.[17] The AICPA's intent is to add transparency and credibility to sustainability reports, with the resulting increase in reliability and trust. The guidance is framework-agnostic and emphasizes that companies must disclose the suitable criteria they use in presenting sustainability information. Attestation has a long way to go in North America, as it continues to lag the EU in the number of externally assured reports. While attest fees may be a potential barrier (at least initially), management should consider the viability of a cost-benefit assessment that weighs the cost of attestation against the favorable impact on the company's ESG rating and related effect on market capitalization. Therefore, voluntary use of attestation services is a key factor to watch.

4. **Pressure from activist shareholders.** Pressure comes in many forms. For example, activists apply pressure on board composition and management incentives in the proxy process. They also use ESG screening criteria to drive investment decisions within their portfolios. Institutional investors (e.g., BlackRock, Vanguard) are communicating pointed messages to boards and CEOs regarding the importance of ESG-related issues and, in particular, climate change. It bears watching their actions closely to see whether their bite matches their bark.

5. **Convergence of frameworks.** Because the SASB standards are specifically tailored to U.S. companies and SEC filings, it is likely that they will continue to gain traction in the United States. But there are other frameworks in use, such as the GRI standards. The effort to harmonize frameworks and metrics is important to achieving a level of standardization that fosters comparability. Progress on this front can raise the level of investor interest further.

> ***Management indifference to sustainability issues in business carries with it the risk of reputation damage, brand erosion, loss of talent, increased shareholder activism, business decline and, ultimately, business failure.***

[17] See "Attestation Engagements on Sustainability Information Guide (Including Greenhouse Gas Emissions Information)" at www.aicpastore.com/AuditAttest/attestation-engagements-on-sustainability-informat/PRDOVR~PC-AAGSUST/PC-AAGSUST.jsp.

6. **Disruptive industry developments.** Royal Dutch Shell's decision is an example of an industry-first commitment to link incentive compensation to climate change. The automobile industry investing heavily in hybrid and electric cars and its attendant effects on the oil and gas and power industries is another.
7. **Egregiously misleading ESG reporting.** If such instances occur, the pressure on the SEC to mandate standards and consider some form of attestation is likely to increase.
8. **Traction on use of COSO ERM ESG supplemental guidance.** This guidance incorporates ESG-specific issues into companies' enterprise risk management (ERM). As companies embrace ESG reporting, this integration effort makes sense. It is possible that internal audit functions may lead the way on this front.

Exactly how the future of sustainability reporting will unfold remains to be seen. Voluntary reporting and voluntary submission to attestation coupled with pressure from activists and convergence of global reporting standards will provide an interesting and powerful mix of forces that could very well move the meter in many boardrooms and C-suites.

SUMMARY

Sustainability reports offer insight as to the potential for enhancing long-term returns and mitigating future risks to enterprise value that often are not on the balance sheet. Management's commitment to sustainability places emphasis on actions, not words; on disruptive innovation, not "business as usual"; and, most important, on leadership, collaboration and transparency. Conversely, management indifference to sustainability issues in business carries with it the risk of reputation damage, brand erosion, loss of talent, increased shareholder activism, business decline and, ultimately, business failure. Needless to say, collective indifference across the marketplace could result in irreparable damage to the planet and civilization as we know it.

Sustainability issues are worthy of attention in both the C-suite and boardroom. For companies remaining in a "wait and see" mode concerning the quality of sustainability reporting, the key factors listed above bear monitoring going forward. New developments could nudge boards and their chief executives to an action orientation toward improving the relevancy and transparency of sustainability performance to investors. With today's evolving optics, it is a wise move for companies to articulate the demonstrable value they contribute on multiple ESG fronts and communicate their message and commitment to the market.