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Telling the Real Corporate Story: ESG Reporting at the Heart of Transparency – Point of View

ESG[1] reporting, or sustainability reporting, and often called non-financial reporting, is maturing and likely to become mandatory, it is essential that organizations focus on quality and report material performance that can credibly inform their stakeholders

In these unchartered times with Covid-19 lockdowns and increasing extreme weather events impacting supply chains and customer behavior, sustainability factors (also called ESG issues) impact on financial stress and viability and are therefore climbing the ladder to become more topical in board discussions than nuances around the IFRS impact on historical financial numbers. Over the coming years our collective view on desirable and viable economic models will change drastically and will focus on the purpose-driven and broader performance of organizations becoming mainstream, and in some cases regulated, for a broad community of stakeholders. This shift will ultimately result in organizations telling the whole story of their performance, their value add and their true impact on society.

On the back of this development we see increasing pressure from funders, investors and society at large for transparency on ESG performance and a growing demand for comparability and reliability of externally disclosed ESG information on the impact organizations have on their environment as well as how they are being impacted. Afterall in the current climate, the appreciation of the vulnerability

1. ESG = environmental, social, and governance issues: here used in the broader sense to indicate material non-financial performance indicators and metrics

of an organization to ESG risks is at the forefront of the mind of investors, regulators, prospective employees and suppliers. But despite this high need for comparability there remains an alphabet soup of ESG reporting standards and assurance mandates that are confusing to the average sustainability professional, let alone an investor or other stakeholder. This is why the recent developments and initiatives from the World Economic Forum Business Council on common ESG metrics, the consultation of the EU Non-Financial Reporting Directive with input from the EFRAG, collaboration between GRI and SASB and IFRS investigating ESG reporting framework options, are so important.

In our view it is highly likely that by 2030 investors, funders, regulators and employees will make their decisions on a company based more on their ESG outlook and performance than on historical financial information. Not only for large listed companies but also for small and medium sized organizations. For that to become a reality confidence in the information has to be a pre-requisite – at the moment a long way off.

Fraud and scandals related to ESG performance have occurred but not yet at large as for financial performance, but with the growing interconnection between ESG performance and financial incentives, it is expected that green- or SDG-washing will evolve to the next level if laws and regulations remain absent. Very much like some of the large remediation programs that financial institutions have had to put in place to rebuild regulator, customer and community confidence we envisage a time when large scale ESG reporting and funding remediations will become common place.

So what is the way forward? How can investors be provided with comparable information that can help them distinguish between an organization with low residual exposure to ESG risk, both physical and transition, that is well managed and strategized to deal with emerging challenges versus one where the fundamental business model is challenged and where management are holding out in an old paradigm as long as they possibly can? And how can stakeholders rely on the information about the impact an organization claims it is making?

It will probably take some time before consistent and clear regulation regulating both reporting and assurance activities is in place covering all these topics. In this point of view we give insights in the current status and recommend practical no-regret actions organizations should take in the meantime.

Alphabet Soup in Need of Harmonization

Throughout the last decade we have seen a proliferation of frameworks and guidance resulting in a scattered European and Global playing field which we became to call the 'alphabet soup'. With a couple of large and well known frameworks like GRI[2], IIRC, GHG protocol and more recent TCFD there is a main stream of preferred frameworks but these do not all have the same focus and scope nor are they fully aligned, raising the risk of cherry picking of frameworks and unclarity to users when reading and comparing information. Furthermore at this moment there is limited regulatory and business backing, non-compliance and lack of assurance has no or limited consequences. Whilst at the same time some EU countries like France, Spain and Italy already require mandatory assurance on ESG information.

The future state of non-financial performance reporting has to be harmonized and grow teeth. The signs that this is indeed taking place is now visible. However, despite the promising developments on the international alignment of non-financial reporting standards much uncertainty remains on how organizations can respond in the interim while we wait for a sustainability standard, potentially from IFRS, and additional regional guidance from EFRAG reflected in the updated EU Non-Financial Reporting Directive which is expected to be effective in 2022.

In our view being transparent about organizational ESG performance and risks is not about complying with regulation. Rather, it is about reporting on the organizations integrated performance in a VUCA[3] world. In consultation with and with input of our experience with leading Dutch organizations who are both users and producers of non-financial information, we developed three rules of thumb as a no-regrets approach. We set this out below:

1) Don't wait for regulation, rather follow a strategic purpose led approach and set out clearly: What is your company strategy with respect to sustainability, how will your organization evolve and transition into a more sustainable enterprise and what should you measure to give stakeholders confidence that you are making progress;
2) Don't perform a wish list or tick-the-box exercise with all SDG's, all IIRC six capitals or all GRI indicators rather be future-focused on material topics and real impact (on the organization and the organization on society and the environment) which the organization can influence and contribute to;
3) Avoid greenwashing or SDG-washing (which often occur unintentionally), by focusing on the key ESG issues that are truly material to the organization and address these strategically and operationally and build tangible evidence criteria that can be independently observed and tested.

Translating this to actions we consider the following:

(1) Take a purpose-led approach

Organizations are increasingly realizing that a proactive approach towards ESG rather than being reactive to developments is beneficial to performance. Scientific evidence shows that developing, maintaining and realizing the clear purpose

2. Global Reporting Initiative, International Integrated Reporting, Green House Gas protocol, Taskforce Climate related Financial Disclosures

3. VUCA = volatile, uncertain, complex, ambiguous

of the organization is not only a questions of taking responsibility but also of potential gains. Telling the story in a credible way aligned with the set purpose and future strategy and direction is key to this using a balanced approach of both positive and negative impacts of the organization. This means bringing performance from financial result driven to value based societal impact moving from short term to long term focus.

Historically many organizations have seen ESG reporting as a way of glossing up an organization to ensure that there is no negative perceptions that can influence share price of an organization. Hence the current general approaches in line with SDG frameworks whilst being beholden to credit rating agencies and other frameworks. Many organizations have growing reporting teams that are "captured" spending their time reporting to various standards and frameworks dictated by different stakeholder groups as opposed to dictated to by the company's strategy and purpose. This needs to change and organizations need to have the courage to go on the front foot, be bold, be clear and stick to what information they see as being key to stakeholder information and perception versus other third parties. We believe that what gets reported on should be organization specific. And that how it gets reported and assured should be aligned market wide to ensure comparability.

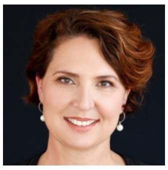
(2) Be future-focused and selective
Understand the most relevant or 'material' ESG risks to the business and the industry through a systematic, stakeholder-inclusive process resulting in a clear materiality analysis. 'Over'-reporting usually does not strengthen the message and performance, so be selective in the reported topics strongly aligned with the purpose of the organization. Taking a science-based approach to determining truly strategic key performance indicators (KPIs) for the organization that link to performance management and rewards is a sensible way forward. Ensure that the organization takes a broader ecosystems based approach so that the selection of KPIs can be explained to stakeholders and performance benchmarked for example to climate science and agreements, to be transparent about the influence, progress and real impact of the organization.

(3) Embed KPIs across the business and track progress
Translate the organizational strategy to clear functional and business level performance metrics. For alignment and implementation cross-silo ESG metrics and targets should be aligned and linked to measurement of progress. As mentioned, incentives must be aligned to focus on these key longer term KPIs. A further aspect that will require attention is the governance related to ESG reporting and functional alignment and role-clarification across the Strategy, Sustainability, Risk Management, Finance and other functions.

It is also important to pay attention to data governance. In our experience it is important to spend time on the definitions of KPI metrics and to ensure that appropriate and sufficient data is captured and not limited to the availability of data, but rather built up from what is most relevant and then expanded upon over time as the organization strives for continuous improvement. In essence , organizations should prepare to bring the quality of non-financial information to the same level as financial information. Looking ahead it is likely that third party assurance will become more common on non-financial performance. It is therefore import to think about the internal controls over this information, as well as data access and management, to ensure long term quality and credibility of the non-financial information.

In conclusion, we believe that in this uncharted territory, both internal and external knowledge sharing should be facilitated to take non-financial reporting to the next level. This should be with peers from inside and outside the same industry to inform the global and European level guidance and standards development process.

Contact us:



Vanessa Otto-Mentz
Partner
+31882883640
votto-mentz@deloitte.nl

Bert Albers
Partner
+31882881104
balbers@deloitte.nl

Han Hindriks
Senior Manager
+31613121048
hhindriks@deloitte.nl

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