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In This Issue

#DeloitteESGnow — Sustainability Disclosure Goes Mainstream

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The nature of value creation is changing in response to global trends — whether related to technology, the role of business in society, or planetary limits, including the effects of climate change. There are a number of forces affecting business, including how investors' information needs are changing in response to these developments. Companies are increasingly taking a wider view of risks and opportunities associated with their business, particularly those related to the interdependent nature of business and to how companies rely on people and natural resources to sustain their business value while also affecting society and the environment.

Business Roundtable recently released a statement[1] on the purpose of a corporation that was signed by 181 CEOs who committed to leading their companies for the benefit of all stakeholders — customers, employees, suppliers, communities, and shareholders. The statement reflects a recognition of the changing expectations of business and its role in society. Executives increasingly take stakeholder considerations into account when they make decisions, and directors have a fiduciary duty to understand the environmental and social impacts of the business and related implications to the company's risk profile and strategy. In an age of transparency, there is an increasing call for companies to demonstrate a broader purpose to build trust with all stakeholders and ultimately drive long-term value. A core concept is that nonfinancial factors can and do have a financial impact that can be realized in both the short and long term.

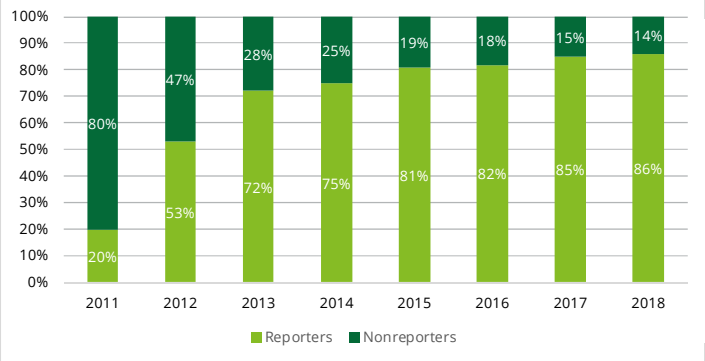
Companies currently are placing more emphasis on the extent, form, location, and content of their environmental, social, and governance (ESG or sustainability) disclosures. Investors, customers, and employees are driving the marketplace transformation and have called for ESG transparency and for bringing sustainability disclosure into the mainstream. Increasingly,

[1] Business Roundtable, "Statement on the Purpose of a Corporation."

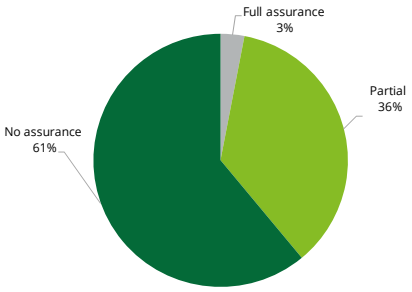
companies are responding by measuring, managing, and disclosing ESG performance, as evidenced by the rise in the number of S&P 500 companies that publish some form of a sustainability disclosure.

We are also seeing a shift in how ESG disclosures are provided. The growing trend in which companies present or refer to broader nonfinancial measures in financial filings[2] and obtain assurance on this information is based on the realization that such disclosures are an important consideration in the evaluation of company performance and future growth. The charts below illustrate (1) the amount of sustainability reports that obtain external assurance[3] and (2) trends in the sustainability reporting of S&P 500 companies over the past eight years:[4]

Sustainability Reporting of S&P 500 Companies



External Assurance of Sustainability Reports



"Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."
— Business Roundtable, "Statement on the Purpose of a Corporation"

Companies that are not harnessing the power of ESG transparency may be losing favor with investors or losing competitive advantage, and they may also be at a disadvantage when attracting and retaining customers and employees.

This *Heads Up* discusses various developments in the marketplace that have resulted in increased pressure on companies to disclose or improve the transparency of ESG topics and the move by some companies toward disclosing such information in their financial filings. The appendix provides links to resources that can help companies manage their ESG information.

Investors and Shareholders

Investor and shareholder interest has led to an increase in the attention companies are giving to ESG disclosure and transparency. The manner in which investors are analyzing an organization's ESG disclosures is similar to that of their financial information assessment, because performance on ESG metrics can affect financial performance.[5] Evaluating ESG information at the onset of a potential investment can help investors better understand and determine the investees' governance and short- and long-term strategies related to addressing material risks and opportunities. Once an investment takes place, investors use ESG information to monitor performance, much in the way they use financial information.

According to a survey of institutional investors,[6] the top five ways that institutions are implementing ESG information are through (1) "ESG integration," (2) "[n]egative screens," (3) "[a]ctive ownership," (4) "[b]est-in-class strategies," and (5) "[i]mpact investing."

[2] According to research published by the Investor Responsibility Research Institute (the *State of Sustainability and Integrated Reporting 2018*) on the sustainability reporting of S&P 500 companies:
- Almost 40 percent voluntarily address some aspect of sustainability in financial filings.
- In their Forms 10-K, 118 companies (23 percent) address sustainability.
- In their annual reports exclusively (e.g., the Chairman's letter and other sections), 80 companies (18 percent) discuss sustainability issues.
- In their proxy statements, 191 companies (38 percent) discuss sustainability beyond board governance and executive compensation.

[3] From the Investor Responsibility Research Institute's *State of Sustainability and Integrated Reporting 2018*.

[4] From research conducted in 2018 by the Governance and Accountability Institute.

[5] See Kahn, Mozaffar N., Georgios Serafeim, and Aaron Yoon, "Corporate Sustainability: First Evidence on Materiality." Harvard Business School Working Paper, No. 15-073, March 2015.

[6] Natixis Investment Managers 2018 Global Survey of Institutional Investors, as reported in *Looking for the Best of Both Worlds*.

As a means of asserting influence, investors often execute their ESG strategies by using proxy voting and shareholder proposals. The 2019 proxy season was the third consecutive year in which environmental and social-related proposals accounted for the majority of shareholder proposals,[7] and many pushed for company action on ESG transparency, strategies, and goals.

Although investors increasingly rely on ESG information and disclosure, they remain dissatisfied with the current state of this content.[8] The lack of standardized investor-grade information prevents them from efficiently evaluating and integrating ESG information into their decision-making process.[9]

Companies may wish to consider the following in connection with providing ESG information to investors that is more standardized and reliable:

- Using a recognized standard for disclosure (e.g., Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), the Task Force on Climate-Related Financial Disclosures (TCFD); see the appendix of this *Heads Up* for more information).
- Subjecting ESG disclosures to the same rigorous internal controls as disclosure of financial information.
- Obtaining assurance on ESG information and disclosure.[10]

A recent article in the *Harvard Business Review*[11] highlights examples of these practices. The case for assurance is also emphasized in a McKinsey survey illustrating investors' belief that sustainability reports should undergo an audit.[12]

"Nearly all responding exchanges (90%) reported having some form of ESG initiative." — WFE Sustainability Survey April 2019, Exchanges Advancing Sustainable Finance.

Stock Exchanges

As a result of the increased investor demand for ESG information, the stock exchanges are acknowledging the importance of such disclosures. According to a sustainability survey[13] conducted by the World Federation of Exchanges, "[n]early all responding exchanges (90%) reported having some form of ESG initiative." In addition, the Nasdaq recently published an ESG reporting guide[14] to encourage disclosure and offer support to companies navigating the evolving disclosure standards. The guide is intended to help companies across geographies and market capitalizations with their ESG reporting efforts.

Europe Accelerates Policy-Making

The European Union (EU) has significantly advanced ESG disclosure by issuing a directive[15] on nonfinancial reporting (the "EU NFRD"), which requires certain companies to disclose nonfinancial information. Depending on the specific requirements determined by each EU member state, information must be disclosed about environmental performance, social and employee matters, human rights performance, and anticorruption and antibribery matters. Since many EU companies now disclose ESG performance, global entities that do not provide such information may be at a disadvantage. Given the ease of global reach by investors and other stakeholders, entities that do not provide ESG disclosures may be looked upon less favorably than companies that do supply this data.

[7] See Westcott, Shirley, "2019 Proxy Season Preview," Harvard Law School Forum on Corporate Governance and Financial Regulation, April 15, 2019.
[8] See Black Sun and Association of International Certified Professional Accountants, *Purpose Beyond Profit: The Value of Value — Board-Level Insights*, 2018.
[9] See footnote 6.
[10] See McKinsey & Company, "More Than Values: The Value-Based Sustainability Reporting That Investors Want," August 2019.
[11] Riesenberg, Tom, and Allen Beller, "Sustainability Accounting Standards and SEC Filings."
[12] McKinsey & Company's Sustainability Reporting Survey, January and February 2019.
[13] WFE Sustainability Survey April 2019, *Exchanges Advancing Sustainable Finance*.
[14] Nasdaq, *ESG Reporting Guide 2.0 — A Support Resource for Companies*, May 2019.
[15] Directive 2014/95/EU, *Non-Financial Reporting*.

The European Commission (EC) is also examining how to integrate sustainability considerations into its financial policy framework. To this end, it adopted a sustainable finance action plan[16] in March 2018 with three main objectives:

- "[R]eorient capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth."
- "[M]anage financial risks stemming from climate change, environmental degradation and social issues."
- "[F]oster transparency and long-termism in financial and economic activity."

In June 2019, the EU published reports containing recommendations from its Technical Expert Group on Sustainable Finance, including:

- *Taxonomy Technical Report*.
- *Report on EU Green Bond Standard — TEG Report, Proposal for an EU Green Bond Standard*.
- *Report on Benchmarks — TEG Interim Report on Climate Benchmarks and Benchmarks' ESG Disclosures*.

In addition, the EC has published guidelines[17] on integrating into existing nonfinancial reporting the recommendations of the Financial Stability Board's (FSB) TCFD. The EU's standardized and regulated forms of nonfinancial reporting have left many U.S.-based companies wondering what the future holds for them.

The U.S. Landscape

The United States has no specific nonfinancial reporting regulations like the EU NFRD; however, recent hearings in the House of Representatives on ESG disclosure (H. R. 4329, the ESG Disclosure Simplification Act of 2019, passed in committee) and in the Senate on climate change disclosure have spurred interest. While it is unlikely that ESG disclosure will be regulated in the United States in the near term, a threshold for reporting this information already exists. Registrants are required to disclose material information to comply with the SEC's disclosure requirements. Thus, if companies determine that ESG topics are "material" under the SEC's requirements, companies should consider the appropriate disclosure.[18] As explained by SEC Chairman Clayton, "If a matter — whether it is considered an ESG matter or not — is going to affect the company's bottom line or presents a significant risk to the business, I would expect [boards of directors] to do something about it. If the matter is material, I also would expect the company to disclose the matter and what they are doing about it. This is consistent with general fiduciary obligations of directors and officers, as well as our disclosure rules."[19]

[16] *Commission Action Plan on Financing Sustainable Growth*, March 8, 2018.
[17] *Guidelines on Non-Financial Reporting: Supplement on Reporting Climate-Related Information*, June 20, 2019.
[18] The SEC has consistently held the view that information "is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision."
[19] *Directors & Boards*, "SEC Chief Takes on Short-Termism and ESG."

Furthermore, the SEC recently issued a proposed rule[20] that would modernize the disclosure requirements in Regulation S-K related to the description of the business, legal proceedings, and risk factors. The proposed amendments would revise Item 101(c)[21] to include as a disclosure topic human capital resources[22] as well as "any human capital measures or objectives that management focuses on in managing the business" if such disclosures would be "material to an understanding of the registrant's business." Further, "depending on the nature of the registrant's business and workforce," human capital measures or objectives that may be material include those "that address the attraction, development, and retention of personnel."

Customers

Customer stakeholders have motivated companies to provide more transparent and accessible ESG performance disclosures. Product expectations are changing as millennials and "generation Z" enter into and mature within the workforce and develop more disposable income of their own. According to Deloitte's 2019 Millennial Survey,[23] these end-consumers will patronize and support companies that align with their values, with 42 percent saying that they have begun or deepened a business relationship because they perceived a company's products or services to have a positive impact on society or the environment. Companies seem to be taking notice of these findings. In a 2019 Deloitte global survey[24] of CXOs, "73 percent said their organizations had changed or developed products or services in the past year to generate positive societal impact." These companies are also passing their sustainability-related demands on to their supply chain.

For example, the ESG performance of large-cap companies in particular is being increasingly scrutinized. Many of these companies are recognizing that much of their ESG impact is generated within their supply chain, and they have established commercial ESG requirements for their supply-chain partners. As a result, prioritization of and attention to ESG matters have increased for private companies as well as for other public small-cap companies that are suppliers to these larger entities.

Smaller public companies' and private companies' ESG risks and opportunities are similar to those of their larger counterparts. A company's responsiveness and transparency related to ESG risks and opportunities can create a competitive advantage, strengthen relationships with critical stakeholders, and promote business resilience.

According to a recent study, 64 percent of people would not take a job with a company that does not have strong corporate social responsibility values.

Employees

Like customers, employees often consider ESG disclosure and transparency to be a key aspect in determining whether they wish to be associated with an organization. ESG disclosure can serve as a differentiator among companies and can enhance an employee's confidence, trust, and loyalty.

According to Deloitte's 2019 Millennial Survey, millennials believe that "business is underdelivering on enhancing employees' livelihoods . . . , improving society . . . , and improving and protecting the environment." In addition, "[o]nly 37 percent of millennials believe business leaders make a positive impact on the world." Companies and senior management teams that are the most closely aligned with millennials with respect to purpose, culture, and professional development are likely to attract and retain the best talent and, in turn, potentially achieve better financial performance.

[20] SEC Proposed Rule Release 33-10668, *Modernization of Regulation S-K Items 101, 103, and 105*.
[21] SEC Regulation S-K, Item 101(c), "Narrative Description of Business."
[22] Human capital issues are considered part of the "S" in ESG disclosures.
[23] The Deloitte Global Millennial Survey 2019 — *Societal Discord and Technological Transformation Create a "Generation Disrupted."*
[24] *Deloitte Insights*, "Success Personified in the Fourth Industrial Revolution" (based on a 2018 survey conducted by Forbes Insights).

According to recent data,[25] nearly 50 percent of employees and 75 percent of millennials would accept less pay to work for a company that is environmentally responsible, and 64 percent of people would not take a job with a company that does not have strong corporate social responsibility values. The message is clear: many employees want to be associated with companies that are making a positive impact on society and the environment. This view is reinforced by SEC Chairman Jay Clayton's observation that "human capital and intellectual property often represent an essential resource and driver of performance for many companies. This is a shift from human capital being viewed, at least from an income statement perspective, as a cost."

Conclusion

As companies navigate a changing global marketplace and macro disruptive trends, establishing and transparently communicating the broader purpose of the organization, enabled through ESG performance, is increasingly critical to demonstrating long-term value creation. Transparency can be a tool to promote resilience and adaptability of an organization in response to growing demands for ESG performance information from multiple sources, most notably investors, customers, policy makers and regulators, and employees.

"As a company, if you ignore sustainability you're going to be worth less." — Tim Freshwater, Goldman Sachs

To maintain and strengthen their license to operate, companies are more intentionally focusing on high quality, credible disclosure that demonstrates a long-term strategy and greater preparedness for environmental and societal disruptions. According to a report published by the GRI,[26] "[t]he latest data shows more than 30 trillion US dollars are now invested using sustainability criteria — a staggering number that is greater than the entire US economy and has grown by 25% over the last two years. Another recent study concluded that more than 80% of mainstream investors now rely upon sustainability disclosures to make decisions." In addition, Deloitte's 2019 Millennial Survey concludes that "millennials and Gen Zs show deeper loyalty to employers who boldly tackle the issues that resonate with them most, such as protecting the environment and unemployment. And as consumers, they are inclined to spend their income on products and services from brands that speak to these issues."

The good news for companies is that increased focus on ESG and broader measurement and management of key performance indicators can help organizations identify, prioritize, and control risks as well as develop new opportunities to drive value, differentiate themselves in the market, and respond to stakeholder concerns.

[25] See "Most Millennials Would Take a Pay Cut to Work at [an] Environmentally Responsible Company," *Fast Company*, February 14, 2019, and the *2016 Cone Communications Millennial Employee Engagement Study*.

[26] Tim Mohin, *The Business Value of Sustainability Reporting*, July 2, 2019.

Appendix — Resources

The following resources can help companies manage their ESG information:

Organization	Resource	Description
Nasdaq	ESG Guide 2.0	Helps global companies adopt best-in-class practices to navigate new developments in the field of ESG.
EU	EU NFRD	Presents the rules for disclosure of nonfinancial and diversity information by large companies. Companies are required to include nonfinancial statements in their annual reports from 2018 onward.
EU and EC	Sustainable Finance	An examination by the EU and EC of how to incorporate ESG factors into finance and investment.
GRI	GRI Standards	"An international, independent organization that helps businesses, governments and other organizations understand and communicate the impact of business on critical sustainability issues such as climate change, human rights, corruption and many others."
SASB	SASB Standards	Provides industry-specific sustainability reporting standards.
TCFD	TCFD Recommendations	Established by the Financial Stability Board to develop "voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders, and insurance underwriters in understanding material risks."
Greenhouse Gas (GHG) Protocol	GHG Protocol Standards	"GHG Protocol supplies the world's most widely used greenhouse gas accounting standards," including *A Corporate Accounting and Reporting Standard*.

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