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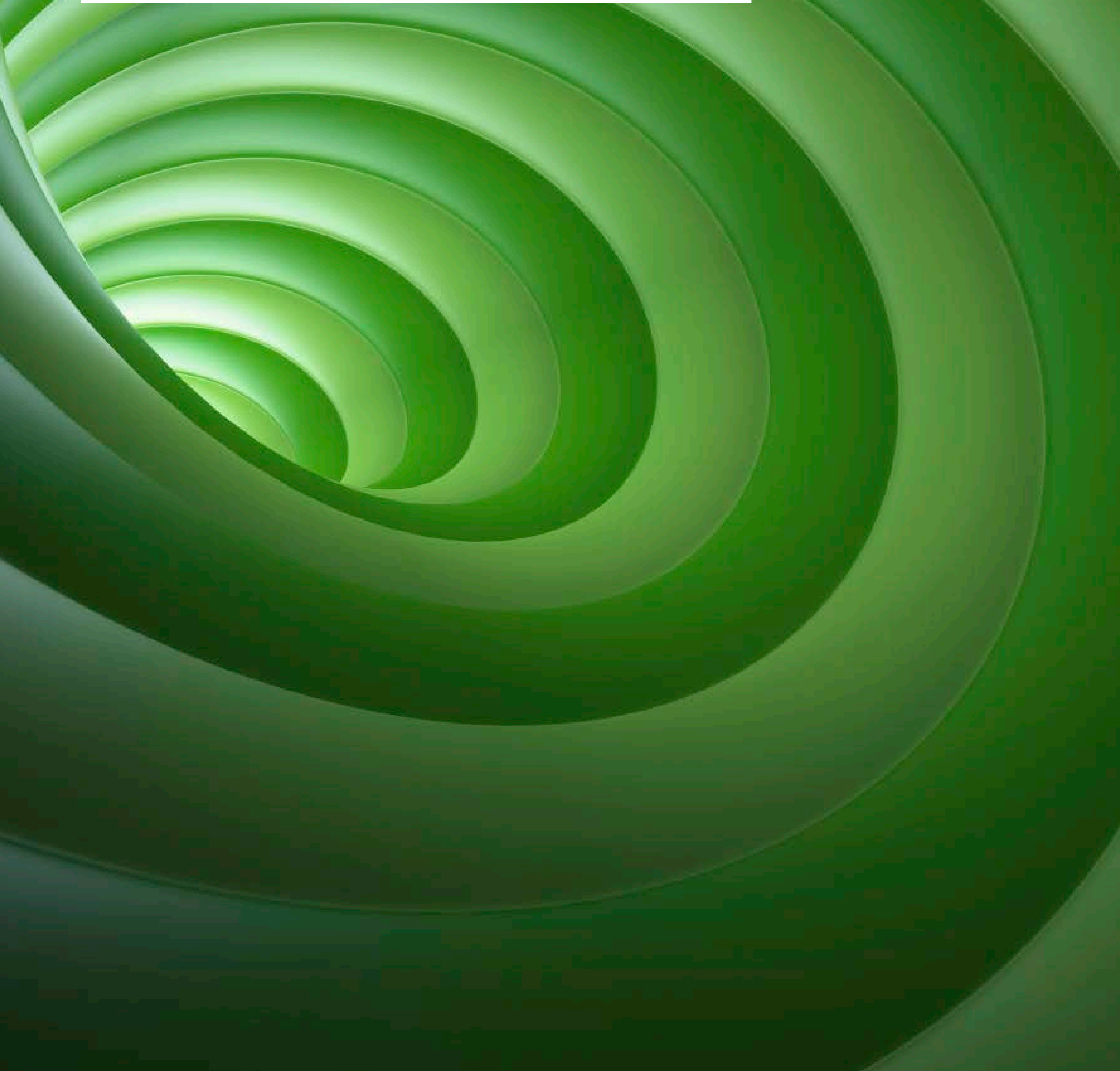
Sustainability disclosure
Getting ahead of the curve



Sustainability reporting has traditionally been voluntary in the United States for the most part. However, heightened regulatory and legal scrutiny, along with other market developments, indicates that the transparency and accuracy of sustainability reporting is increasingly important.

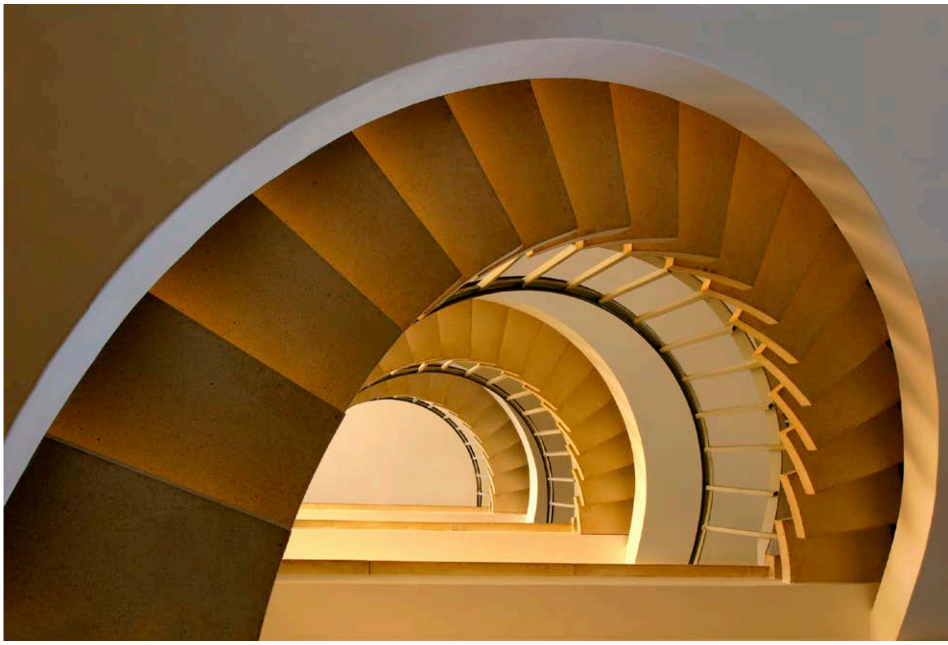
For example, recent high-profile incidents involving automotive, big-box retail, and energy and resources companies highlight growing attention to public company nonfinancial disclosures—such as how environmental, social, and governance (ESG) or sustainability topics are disclosed to stakeholders, especially investors. In addition, the climate change agreement reached at the 2015 Conference of Parties (COP21)[1] and several other important developments highlight the movement toward more standardized, transparent, and meaningful ESG disclosures that drive value for users of the reported information and for public companies themselves. The most highly visible developments include:

- On November 4, 2015, the World Federation of Exchanges (WFE) issued ESG guidance for consideration by WFE member exchanges in promoting transparent and efficient markets. This guidance covers "the purpose, practicality, and materiality of ESG data"; recommendations regarding ESG disclosure principles and data; and implicit counsel on improving and harmonizing related management practices.[2] The guidance includes a list of suggested indicators that could serve as a starting point for WFE exchanges to introduce additional disclosure considerations for listed companies, as they represent data points that are commonly reported to the marketplace. The indicators could also facilitate more meaningful engagement between investors and listed companies around ESG risks and opportunities.

- Investors and capital markets institutions are increasingly factoring ESG performance into investment decisions. In a September 2015 ESG survey published by CFA Institute, 73 percent of investors responding to the survey said they take ESG issues into account in their investment analysis and decisions.[3] The top reason investors consider ESG-related information is not to derive reputational benefit but to determine whether a company is adequately managing risk.[4]

- In 2014, the European Parliament passed a directive on disclosure of nonfinancial information, including environmental, social, employee-related, human rights, anticorruption and bribery, diversity, and other legal aspects related to sustainability. Once it becomes law and its provisions are adopted by EU member states in 2016 and 2017, the directive is expected to impact many US companies based on the scoping requirements for disclosure under this directive.[5] The directive will require nonfinancial disclosure to be available on the company's website within six months from the end of the reporting year.

Driven by these and other factors, stand-alone sustainability reporting is accelerating in the United States. Sustainability reporting helps organizations set goals, measure performance, and manage change around ESG impacts and how they drive value to the organization. At this time, sustainability reporting is primarily guided by the Global Reporting Initiative (GRI) sustainability reporting guidelines.[6] GRI provides a framework to guide the sustainability reporting process and performance metrics, which results in a sustainability report that conveys disclosures on an organization's impacts—positive and negative—on the environment, society, and economy.



As sustainability reporting continues to mature and evolve, companies can gain a better appreciation of how ESG impacts drive their business—"you can't manage what you don't measure." They can also build trust and credibility with a growing number of stakeholders that demand greater insights into how a company manages risks and opportunities related to ESG topics. From an operational perspective, businesses are increasingly applying an ESG lens as they consider the full costs and availability of required inputs, beyond direct material input costs, to the development and delivery of their products and services. Such factors include investment in labor and human rights practices, as well as environmental practices and impacts, across the supply chain—from sourcing of raw material to delivery to the end customer. From a capital markets perspective, investors are seeking to understand not only how corporations manage risk and identify opportunities related to ESG topics, but also how such organizations embed those considerations into their business strategies.

Multiple market developments, in addition to those cited below (Figure 1), point to even more rigorous sustainability reporting and disclosure expectations ahead. In light of those growing expectations, and as public companies gain increasing insight into ESG value drivers based on improved ESG reporting programs, those companies are also looking for clearer standards for sustainability reporting and disclosure against which market participants will evaluate company sustainability performance.

Existing sustainability standard-setting and reporting initiatives are available to help companies determine how to credibly communicate sustainability performance (Figure 2). By establishing a disciplined, credible sustainability reporting and disclosure program using a recognized framework, companies can effectively prepare for changing marketplace demands for ESG transparency and manage risk more effectively. They may even gain competitive advantage. In addition, such a program can help management expand the consideration of dimensions that inform how their business operates, enhancing their ability to sense and respond to heightened risks in an increasingly resource-constrained world, as well as stay ahead of future reporting and disclosure mandates.

Figure 1. Market drivers and the sustainability reporting landscape

Market push

Stock exchanges

November 2015: World Federation of Exchanges (WFE) released guidelines, including a set of 33 ESG indicators for member exchanges to consider adopting

September 2015: United Nations Sustainable Stock Exchange (SSE) initiative issued Model Guidance (MG) on reporting ESG information to investors

Standard-setting and reporting initiatives

- The Global Reporting Initiative **(GRI)** G4 Guidelines
- The Sustainability Accounting Standards Board **(SASB)** provisional standards
- The International Integrated Reporting Council **(IIRC)** International <IR> Framework
- The Global Initiative for Sustainability Ratings **(GISR)** CORE platform

Regulatory developments

- EU directive on disclosure of nonfinancial and diversity information adopted in April 2014 to go into effect in 2017
- US SEC Conflict Minerals disclosure rule (2013)
- SEC Guidance Regarding Disclosure Related to Climate Change (February 2010)

Market pull

Institutional investors

- Over 80% remain dissatisfied by "how risks and opportunities are identified and quantified in financial terms"
- Nearly 80% remain dissatisfied by the "comparability of sustainability reporting between companies in the same industry"

Source: Verdantix, "The Future of Sustainability Disclosures," 2015.

CFA Institute Survey

- 73% said they take ESG issues into account in their investment analysis and decisions, mainly to help manage investment risks
- 57% considering ESG issues integrate them into the whole investment analysis and decision-making process

Source: CFA Institute, "Environmental, Social, and Governance (ESG) Survey," 2015.

Corporate engagement on climate change

- 154 companies, with market cap $5T, signed the American Business Act on Climate Pledge to demonstrate support for climate change agreement at COP21
- US senators urge SEC to implement steps to elicit greater transparency for investors on material risks posed by climate change

Source: White House Office of the Press Secretary, "White House Announces Additional Commitments to The American Business Act on Climate Pledge," December 1, 2015.

Figure 2. Commonly referenced standard-setting and reporting initiatives

	Year founded	Type	Audience	Form of report	Focus
CDP	2000	Reporting and rating	Investors and other stakeholders	CDP questionnaire	Provide investors with climate change, water, and carbon data
DJSI	1999	Rating	Investors	RobecoSAM questionaire	Evaluate the sustainability performance of the largest 2,500 S&P firms through a family of indices
GISR	2011	Rating	Investors and other stakeholders	Center of Ratings Excellence (CORE) program	Steward an ESG ratings standard to accelerate the contribution of organizations worldwide to sustainable development
GRI	1997	Reporting	Broad set of stakeholders	Sustainability report	Empower sustainable decisions through established standards and a global, multi-stakeholder network
IIRC	2010	Reporting	Providers of financial captial	Integrated annual report or standalone report	Establish integrated reporting and thinking within mainstream business practice for both public and private sectors
SASB	2012	Reporting	Investors in US public companies	SEC 10-K, 20-F filings	Establish and improve industry-specific metrics for investors in the US

A closer look at heightened risks

ESG issues are clear global market concerns. The Global Risks 2015 Report of the World Economic Forum includes an assessment of the likelihood and potential impact of 28 risks to our planetary well-being. Four of the 10 most likely risks, and four of the 10 risks with the greatest potential impact, are environmental or social in nature. In this context, issues such as how companies address climate change and what steps they take to reduce energy and water consumption are growing concerns.[7]

Broadly, ESG issues present three types of reporting-related risks to businesses: legal and disclosure, competitive, and market valuation.

Legal and disclosure risk. To date, the moderate pace of uptake of standardized ESG reporting in the United States compared to other countries is thought by some to reflect fear among companies that expanded disclosure will be used against them in today's litigious environment.[8] A greater risk, however, could lie in the absence of reporting or for failing to implement a rigorous, disciplined reporting program that provides accurate and transparent information to stakeholders and authorities.

For example, a state attorney general's recent high-profile investigations are shining a bright light on public company climate change disclosures and the way in which risks are disclosed to investors. Whether or not wrongdoing is found, the potential negative publicity associated with such investigations is likely to be of concern, and possibly cause harm, to companies.[9]

In response to the demand for greater standardization in such ESG reporting, leading sustainability standard-setting and reporting initiatives highlighted in Figure 2 are focusing efforts on improving the applicability and usability of standards and guidelines in terms of generating information that is relevant and useful to decision making.

Competitive risk. ESG performance is increasingly a consideration for people when they are deciding whether to buy a company's products or go to work for a particular company. Price and functionality, or pay and benefits, usually trump other considerations. But sustainability topics are progressively driving more of these considerations as a generation that's coming of age amid environmental and economic strains and continuing global strife assumes buying power and investment decisions. An estimated

$40 trillion or more in assets are being transferred from baby boomers and older Americans to their heirs in the next 40 years.[10] Public companies will likely be affected by the younger generations' changing expectations and investment and purchasing decisions, as those decisions may be increasingly influenced by how an organization's transparency and the ESG impacts of its business are perceived. Adherence to recognized frameworks or standards may also become an increasingly important mechanism to communicate performance around ESG topics to this audience.

> "As a company, if you ignore sustainability, you're going to be worth less."
>
> – Goldman Sachs[16]

Additionally, companies wanting to do business with the federal government have an added motivation to adopt sustainable practices. Executive Order 13693, issued by President Obama in May 2015, requires federal agencies to meet sustainability goals that lead to a reduction in greenhouse gas (GHG) emissions and stipulates that 95 percent of new government purchases are to comply with environmental requirements.[11]

Market valuation risk. A top question among corporate board members and executives regarding the value of ESG initiatives and disclosure is whether such investments add shareholder value.[12] Some leaders are still wary that investments in sustainability-focused initiatives are purely added costs with limited immediate benefit.

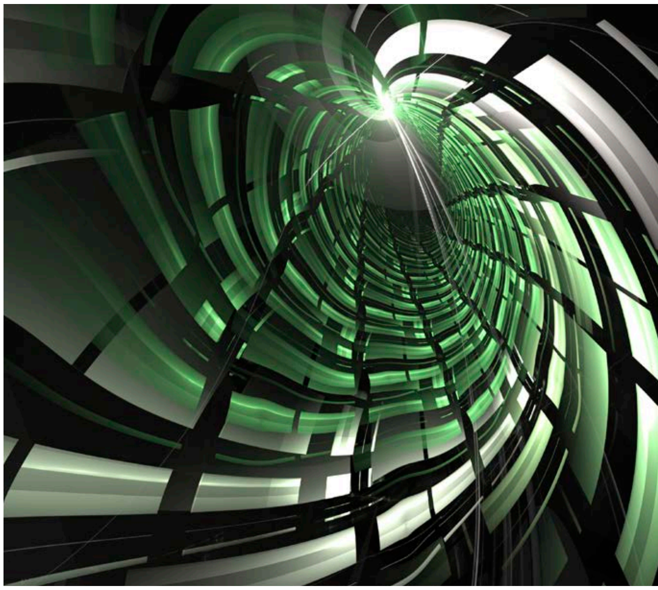
Recent research suggests that, from a market valuation standpoint, the opposite is true. US sustainable investment grew from $1 out of every $9 of assets in 2012 to $1 out of $6 in 2014, according to investment banking firm Morgan Stanley. And firms that actively pursue improvements in ESG metrics tend to have lower costs of capital and higher operational and stock price performance.[13]

In fact, Morgan Stanley has based recent price targets and buy recommendations for selected stocks in the apparel industry on how effectively companies manage ESG topics. The firm provides ESG performance data in the form of a sustainability index, reporting on a range of ESG initiatives, including reducing or conserving water usage, waste, and raw materials.[14]

Investigation by Harvard Business School researchers also points to the benefits of ESG commitment. Researchers there found that "firms with good performance on material sustainability issues significantly outperform firms with poor performance on these issues, suggesting that investments in sustainability issues are shareholder-value enhancing."[15]

Investor interest in ESG—the information gap

Corporate directors and executives may feel they are receiving mixed signals regarding the importance of ESG topics to investors. They can be swamped with questionnaires and surveys from investors, ratings agencies, media outlets, and others regarding their company's ESG performance, yet the topic is seldom raised on quarterly earnings calls. This disconnect is not altogether surprising considering the strong focus on financial performance that is characteristic of earnings calls. There may simply not be time for ESG topics to come up, especially if management is not proactively communicating how ESG topics drive corporate performance and translate into value.



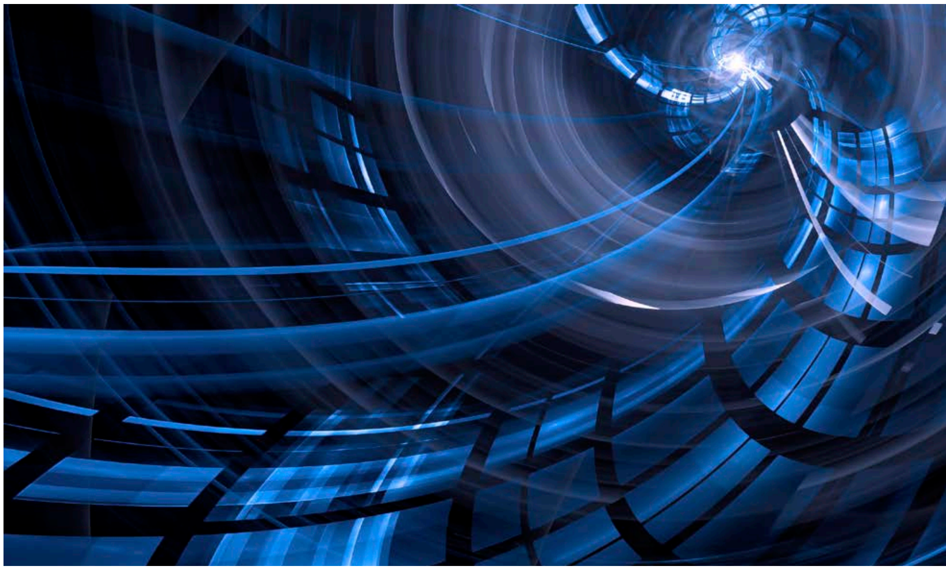
The lack of inquiries, however, can create a troubling information gap, where in many cases corporate executives—especially CFOs—are not prioritizing these issues at the same level as investors may be. A recent ESG survey indicates that over 80 percent of investors are dissatisfied by "how ESG risks and opportunities are identified and quantified in financial terms."[17] Moreover, nearly the same percentage of respondents is dissatisfied with the "comparability of sustainability reporting between companies in the same industry."[18] As a result, investors often look to third-party ratings and data providers to gain access to ESG data sets, generated primarily through company survey responses (or lack thereof), external research, and other inputs. Tedious as they may be to complete, those investor and ratings agency surveys have become an increasingly important step in the ESG information value chain and the ability of investors to consider ESG factors in the absence of standardized, accessible, and comparable ESG reporting and disclosure by companies. Given this survey-driven ESG information value chain, companies are subject to increasing risk if their corporate leaders are not confident in the accuracy and reliability of those multiple ESG survey responses.

Complicating matters further, sustainability reporting and disclosure, in many cases, currently lacks the discipline of established management systems, processes, and controls exhibited by financial reporting. Financial reporting for publicly listed companies is regulated by the federal securities laws in the United States, which serve to instill discipline and sophistication in financial reporting through, for example, Form 10-K and 10-Q reporting. A vital challenge to driving standardization in the sustainability reporting process is multiple and varied ESG topic areas and the variation in units of measure across ESG topics. Performance indicators across ESG topic areas do not distill down into one standardized unit of measure, as is the case with the dollar in traditional financial reporting.

For example, energy consumption is measured differently around the world; some use gigajoules, while others use kilowatt hours. Social topics are measured in headcount, training hours, and injury rates, among other factors.

As those examples suggest, reporting process and control considerations across ESG subject matter areas are unique as compared to financial reporting. They challenge companies to establish effective governance practices and accountability to drive high-quality reporting. The absence of accurate, relevant, and meaningful ESG data that can be used to inform management decision making and measure performance makes it harder for companies to create value based on the information. It also leaves investors struggling to interpret and incorporate ESG information into their decision making in a meaningful way.

It is important for management to identify, weigh the relative risks of, and prioritize the sustainability issues that are most meaningful to both the company and its external stakeholders. Then it is important not only to collect consistent and complete information, but also to translate it into an appropriate unit of measure that can then be reported and interpreted. Just as the accounting profession set standards in the 1970s for reporting financial information, sustainability accounting standards for factors such as energy consumption, fair labor practices, data security, and supply chain management are needed to fairly represent a company's performance.



What to do while reporting standards continue to evolve?

For corporate decision makers, this is not the time to sit back and watch the sustainability landscape progress while waiting for a single harmonized standard or clear mandate for sustainability reporting and disclosure. Instead, it is time to engage and proactively help influence future sustainability reporting and disclosure expectations by analyzing ESG impacts and designing a plan to integrate ESG considerations into the business model and reporting cycle in a manner that reinforces value creation while minimizing risk.

As demand for sustainability reporting continues to grow and gain traction, so will the expectation that such reporting be accurate and reliable. The growing desire for assurance presents an opportunity for CFOs in particular and their corporate finance organizations to lead the development or refinement of sustainability reporting initiatives. CFOs, already responsible for corporate transparency in the form of orderly and accurate financial reporting, have the tools and resources to capture the potential influence of ESG issues on enterprise performance and valuation.

Assurance is a critical step in establishing a disciplined, credible sustainability reporting and disclosure program in response to those marketplace expectations, with the goal of enhancing confidence in the reported information for the benefit of the intended users of the information. As evidence of that, CDP[19] (formerly the Carbon Disclosure Project) and the Dow Jones Sustainability Index[20] (DJSI) award additional "points" to companies for obtaining external assurance. In addition, sustainability assurance can drive value for the reporting company by identifying opportunities for performance improvements.

Whether starting a sustainability reporting program or refining an existing one, corporate decision makers, including CFOs, may benefit from the following considerations:

Understand material topics and report more effectively

- Develop a stakeholder engagement strategy to contribute to a better understanding of material ESG issues that can impact and add value to strategic planning, operational management, capital investment, and disclosure decisions.

- Actively engage with internal and external stakeholders to continually evaluate the relative prioritization and trade-offs of ESG issues relevant to diverse stakeholder audiences and to elicit valuable insights to inform the company's perspective on its biggest ESG impacts.

- Secure high-level executive buy-in, support, and feedback around ESG disclosure initiatives to drive awareness, prioritization, and accountability for sustainability efforts within the company.

- Create a centralized inventory of current and emerging sustainability reporting and disclosure developments, as well as relevant regulations, to help drive reporting strategy and enable identification of gaps and opportunities to improve reporting processes and performance.

- Develop a sustainability strategy and reporting program that clearly articulates the organization's sustainability strategy, risks, and opportunities and performance on material ESG topics responsive to internal and external stakeholder expectations.

Establish credibility and build trust through transparency

- Prepare sustainability disclosures in accordance with established sustainability standards and reporting frameworks (e.g., GRI, SASB, CDP, or DJSI, among others) and make ESG information publicly available to communicate the company's command of ESG topics, risks, and opportunities impacting its business and driving value for stakeholders.

- Design and maintain well-documented and thorough internal reporting processes, controls, and procedures for ESG disclosure to help improve the value of reporting, both internally and externally, and to address legal, disclosure, competitive, and market valuation risks.

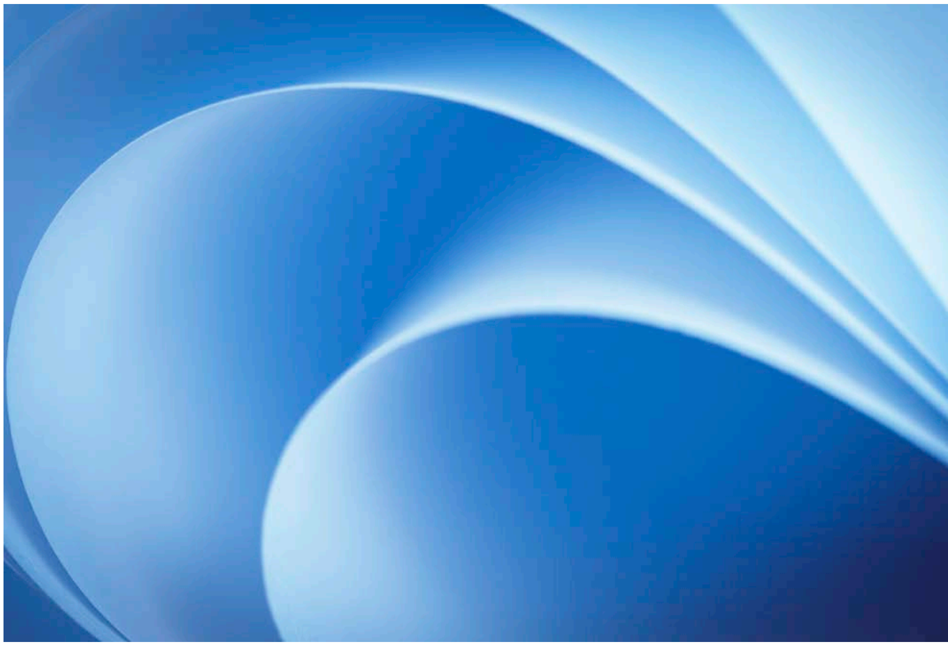
- Establish and publicly communicate ESG targets and key performance indicators (KPIs) to drive ESG performance management and process efficiency and address stakeholder expectations.

- Engage the internal audit function to serve as an important component of the ESG management reporting system by enhancing the reliability of ESG performance reporting.

- Obtain external assurance to increase stakeholder confidence in the integrity and reliability of ESG reporting.

Heed the growing call to action

Scrutiny around how companies conduct business is intensifying as investors, regulators, and consumers seek more details on and deeper insight into the effect of business operations on the environment, society, and regulatory compliance. More rigorous analysis and disclosure of ESG performance will be essential for companies to improve credibility and trust among an expanding set of stakeholders and, at the same time, drive performance in a manner that can be transparently evaluated by internal and external stakeholders. Taking steps now to prepare for more rigorous reporting and disclosure demands from investors and the capital markets, as well as regulators and customers, will help companies meet evolving 21st-century expectations.



Endnotes

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