GPPC

Perspectives on ESG reporting

Americas roundtable – The Future of ESG Reporting Explored

On 15 December 2021, the GPPC[1] brought together 13 professionals representing various stakeholder groups in the corporate reporting ecosystem[2] to explore Environmental, Social, and Governance (ESG) corporate reporting and assurance of the future. Individuals from the United States, Mexico and Canada, in addition to the broader Latin American region were invited based on their knowledge and expertise relative to ESG reporting and assurance matters. The roundtable was conducted virtually, with technical operations based in Washington, DC.

The Americas roundtable was one of a series of regional discussions, held under the Chatham House Rule[3], that explored the current ESG reporting landscape in terms of 1) Where we are now, 2) Where we want to go, and 3) How to get there. Grounded in the understanding that there may be a disconnect between what current accounting and auditing reporting practices require and permit, and what some investors and stakeholders are expecting and demanding, the discussion was designed to explore potential approaches to better align corporate reporting and auditing standards with stakeholder and societal objectives.

The report below draws out key points that were made by the participants at the roundtable discussion. The roundtable participants' remarks are quoted (in italics) throughout the report. In accordance with the Chatham House rule, attribution of quotes is by category of participant rather than name and organisation. It is designed to help understand the perspective from which comments were made, rather than to suggest that any position is typical or otherwise of a particular stakeholder group. For a full list of participant categories, please see Appendix A.

1 **Where we are:** Exploring current gaps

1.1 The current financial reporting system and support infrastructure are outdated

There was broad consensus among participants that investors are demanding more and more information to make accurate decisions about where to allocate capital, but many participants asserted that existing corporate reporting and auditing standards, regulatory requirements, and technology, have not kept pace to meet this growing demand.

> *"The current reporting model is based on manufacturing economy, so we're not recognizing the intangibles we need to recognize, which leads to a huge gap between book value and market*

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[1] The Global Public Policy Committee (GPPC) is the global forum of representatives from the six largest accounting networks: BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC, which has as its public interest objective the enhancement of quality in auditing and financial reporting.

[2] Participants represented stakeholder groups including investors and asset managers, investor associations, corporate preparers and ESG leaders, business organizations, those charged with governance (TCWG) including audit committees and corporate boards, auditors/assurers, and professional bodies.

3 When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.

capitalization. And now with investors clamouring for the ESG data, we have openly said we believe the reporting model is actually broken and it's not fit for purpose."

Investors and investor associations

One assurer/professional body participant added that current reporting is designed to present a historical perspective of what you have achieved, and not necessarily to capture forward-looking information or assess what your impact will be. There is a need for standards both for reporting on ESG performance metrics in terms of what a company has accomplished to-date and for capturing a more forward-looking view on impact. Further development of standards in both these areas would be beneficial.

There was, however, one investor association participant who disagreed that the reporting system was entirely *"broken,"* believing that the existing set of principles-based financial reporting standards encompasses the new form of risks generated by a new economy and the *"energy transition."* Rather the degree of knowledge and awareness of how risks relate to financial impact is what is evolving –there is a need for a "*deeper appreciation of these risks"* and not necessarily a new set of standards.

1.2 Absence and/or inconsistencies of policies and guidance are stifling progress

From the perspective of one business organization participant, the domestic regulatory and policy environment in the U.S. is lagging behind, although important Securities and Exchange Commission (SEC) rulemakings on ESG-related disclosures are expected in 2022. Absent these regulations, companies continue to struggle with *what* they are measuring and what different jurisdictions are or will be requiring in the future.

Additionally, there are key differences across jurisdictions on important concepts such as how materiality is defined. In the U.S., companies are bound by a Supreme Court definition of materiality and the related definition of what constitutes a "reasonable investor," when determining what to disclose, while governments in other countries may choose to expand beyond these definitions (as is the case in the EU). Furthermore, other local policy issues such as the litigation environment in the US and the UK's impact assessments of regulations on economic competitiveness must be fully factored into the development of reporting systems and global standards to ensure interoperability.

"Standardization is a goal. Coordination among jurisdictions is something that is important, and the assurance work is important. I think the details [in getting there] will be difficult."

Companies and business organizations

1.3 Data: Issues with quality, availability, and comparability

Quality

A common refrain among participants was the idea that not all data is created equal. ESG data is not homogenous. From the perspective of one company participant responsible for ESG reporting, certain data solutions offered by third-party vendors in the ESG space are simply *"not actionable."*

The quality of models, results, usability and reliability varies from an action-oriented perspective, but generally do not yet meet the standards of quality that companies need to meet investor demand.

> *"Garbage in, garbage out. Poor data quality can result in poorly informed investment decisions, which impacts capital markets."*

Companies and business organizations

Still, there was agreement that investors really do need more reporting, and indeed, some companies are reporting all kinds of important information for which investors have called. However, one investor organization participant noted that the information presented often lacks rigor and controls, and for the most part is not audited. What's more, many involved in ESG reporting aren't part of the usual financial reporting infrastructure, so you're not seeing the same level of quality in the delivery of data.

Availability of data

In many instances, according to one business organization participant, companies are finding it challenging to make climate-accounting disclosures in complex areas such as Scope 3 emissions. Whereas Scope 1 and Scope 2 disclosures are based on historic, backward-looking information and utilize existing metrics to measure risk, Scope 3 relies heavily on calculations and estimations. The same participant noted that certain companies believe these types of disclosures are akin to nothing with which they have previously dealt, and the technologies for capturing the data to support these disclosures has not evolved quickly enough to meet regulatory and investor demand.

> *…You're looking at supply chain, looking at parts, looking at usage of products – you're looking decades into the future – talking about issues where public policies have been put in place, where there are talks about technologies that don't exist …You're asking companies to disclose things that are not only very difficult to do, but they find it nearly impossible to do. And how are you going to build our assurance around that? That's actually a fairly big flashpoint in the discussion of climate. It's not that companies don't want to disclose it."*

Companies and business organizations

But one investor association participant took a different perspective on the data issue, suggesting that there is almost too much data out there. Companies are reporting a wealth of information but are not assigning "weight" to each data point against what is actually material to investors.

> *"But what they're finding difficult to ascertain is which data points are actually material. And if they give equal weighting to each data point, then they're going to come up with the wrong investment analysis. They're struggling with which are the material data points."*

Investors and investor associations

Consistency and Comparability

From a TCWG perspective, one Board Member participant noted that across the Boards on which they sit, ESG in general, and in particular, climate accounting, is showing up in different places.

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"… it feels like more art than science, and the comparability of information in the marketplace and that <u>we want our regulators to provide</u> us with guidance isn't necessarily there."

TCWG

2. Where we should go: Corporate reporting of the future

2.1 Where should ESG information be reported?

Many commenters across participant categories expressed the notion that ESG reporting can serve different purposes depending on the user. Generally, commenters believed there should be differentiation between what is reported in or *with* a company's financial statements and what should be transmitted through other sources such as Corporate Sustainability Reports (CSR). Through the eyes of one company participant, factors that would drive information toward financial reporting (i.e., financial statements, proxy statements, MD&A, etc.) include materiality to business strategy and performance, having performance metrics attached to how risk and strategy are managed, having quantitative targets against which to measure performance that is material to generating value. On the other hand, although there are stakeholder demands for ESG information that is "programmatic, "policy-oriented," or "storytelling," that information should exist somewhere but does not belong in the financial statements.

One business organization participant noted that it was crucial to understand the implications of where information is disclosed on how the information is reported, down to the actual words used. The required language for specific reports is dictated by regulation in many jurisdictions, and these requirements vary, as does how various terms in reporting are understood by different audiences.

2.2 A global baseline for standards

There was widespread support among participants for a global baseline of ESG reporting standards which could be supplemented by additional standards for matters of local importance. Many participants across categories specifically applauded the creation and direction of the International Sustainability Standards Board (ISSB), seeing it as the best path forward toward a single set of globally accepted standards.

But one business organization participant cautioned that not all countries have the same commitment to transparency, nor do they share the same values on issues like human rights or social responsibility. An investor association participant added that absent basic concepts like rule of law or a strong regulator with enforcement capability, *"standards aren't really standards,"* so there needs to be serious consideration of these factors at the global level.

2.3 A global taxonomy

In addition to establishing a global baseline for standards, one investor association participant believes that a "Digital first approach" for tagging ESG data should be established going forward. Currently, there is no global digital taxonomy resulting in comparable items being tagged differently. This requires a large amount of manual intervention which defeats the purpose of a digital platform.

Another TCWG participant agreed, adding that interoperability should exist not only between standards, but also at the data level. Thus, common data definitions should be established as well.

2.4 The criticality of looking at ESG issues by industry

While establishing comparability and consistency between standards and data should be a key objective, one investor participant pointed out that having the flexibility to tailor standards and data based on industry is of great importance, as well.

"If you look at the "standard" accounting standard, there's no need to look yet at accounting issues through the lens of industry. Whereas a lot of sustainability or ESG issues really should be evaluated industry by industry. Climate change impacts different industries differently."

Investors and investor associations

A TCWG participant agreed with this point, adding that "*If it becomes one-size-fits-all, it may become meaningless."*

2.5 An important role for assurance

Several roundtable participants from across categories agreed that some level of assurance over ESG reporting is important so that investors have confidence in the reliability of the reporting that drives their investment decisions.

"I'm definitely a fan of having some level of assurance because otherwise it really is the wild, wild West."

TCWG

One investor association participant expanded on the concept of assurance, pointing out that by its very nature of being grounded in probing, assurance also can improve the rigor of the disclosures. However, currently, there are some inconsistencies in assurance over ESG information, including who provides it, to what level (i.e., limited or reasonable), and what information is actually assured. Another investor association participant added that where assurance is taking place, it is in areas that are easily measurable and not over qualitative information which is a real issue for investors. These inconsistencies in sum are creating confusion in the marketplace.

"There is a lot of limited assurance over certain metrics; it's not accounting firms providing that assurance for the most part. I think people are taking comfort in the idea that there's assurance without really understanding what that assurance does. In the long run, it has to be moving back toward the profession that is so much better prepared."

Investors and investor associations

3. How to achieve the desired future state

3.1. Governance

A business organization participant observed that when it comes to gathering the information to generate an ESG report, often organizations have the responsibility for ESG split across different parts of the company. However, a well-functioning system of reporting, “someone must own it.” Good governance, in this regard is crucial to create a connected process between the sustainability team, finance and investor relations. One Assurer/Professional Body representative noted that companies should be encouraged to consider governance in terms of what structure is necessary to ensure cohesiveness among the different organizational components which have reporting responsibilities.

> *“You may have different governance structures for the strategy component [around ESG] versus reporting, and they have to be connected and working together and informing one another. But it’s not necessarily going to be the same person or same people…”*

Assurers and professional bodies

3.2 Aligned stakeholder support for a global baseline

While there will be significant challenges to establishing and adopting a single set of global standards across geographies, one TCWG participant emphasized the importance of key constituent groups -- the corporate community, the investor community, the accounting community – remaining actively aligned on the global baseline approach. Likewise, it will be incumbent on the ISSB or the designated global standard-setter to signal to the marketplace what the starting point for standards is, and then adopt the *“well-worn”* process of taking a set of existing standards, embarking on specific improvements projects, and setting forth in a transparent manner the Board’s agenda going forward. The process must necessarily include the feedback of all relevant stakeholders – industry groups and associations, investors, issuers, and TCWG.

3.3 Greater regulatory supervision and policy/incentives

According to one company participant, policy risk is the greatest transition risk that companies are currently facing, which in turn has implications on market risk and emerging technologies. Government policy is defining a lot of the new and emerging areas that will require company monitoring and reporting. Having policies in place will help take out uncertainty in the marketplace and help companies with decisions on what and how to measure and report.

> *“It’s a different risk profile when you have clearly defined regulations and standards to follow.”*

Companies and business organizations

This risk was further demonstrated by a company participant whose company, absent a standard methodology for measuring employment equity, developed its own some years ago. Now, the company is facing three different local government policies governing employment equity which dictate methodologies that neither align with each other, nor with the company’s own. In this case, the fragmentation and resulting challenges were a direct result of businesses moving a step ahead, and policymakers a step behind.

One assurer/professional body participant wondered whether the ability to accelerate the necessary technology for a robust system of ESG reporting would improve with some type of government intervention – whether through policy and/or incentives.

> *"I think it's believed that a lot of the technology that we need to get us to where we're going doesn't exist today or hasn't been scaled in a way that will get us to our 2030 and 2050 goals."*
>
> *Assurers and professional bodies*

And finally, a TCWG participant broke down the need for government policies and incentives as a simple function of human behavior:

> *"You tend to get better outcomes when you actually measure things, because you can manage them, and you tend to get outcomes that are aligned with incentives or penalties … If you want to nudge free market behavior in a certain way, you have to put in absolute requirements that have some teeth and/or some real incentives. And then you have to require measurements against them."*
>
> *TCWG*

The future of ESG reporting explored

Americas roundtable

Appendix A: Participant Categories

Participant Category	Description
Companies and business organizations	Publicly-traded companies or organisations that represent them
Investors and investor associations	Investment funds or associations representing investors
Academics and policymakers	Professors of accounting or civil servants with a role in corporate governance
Assurers and professional bodies	Auditors at GPPC member firms or leaders at professional bodies

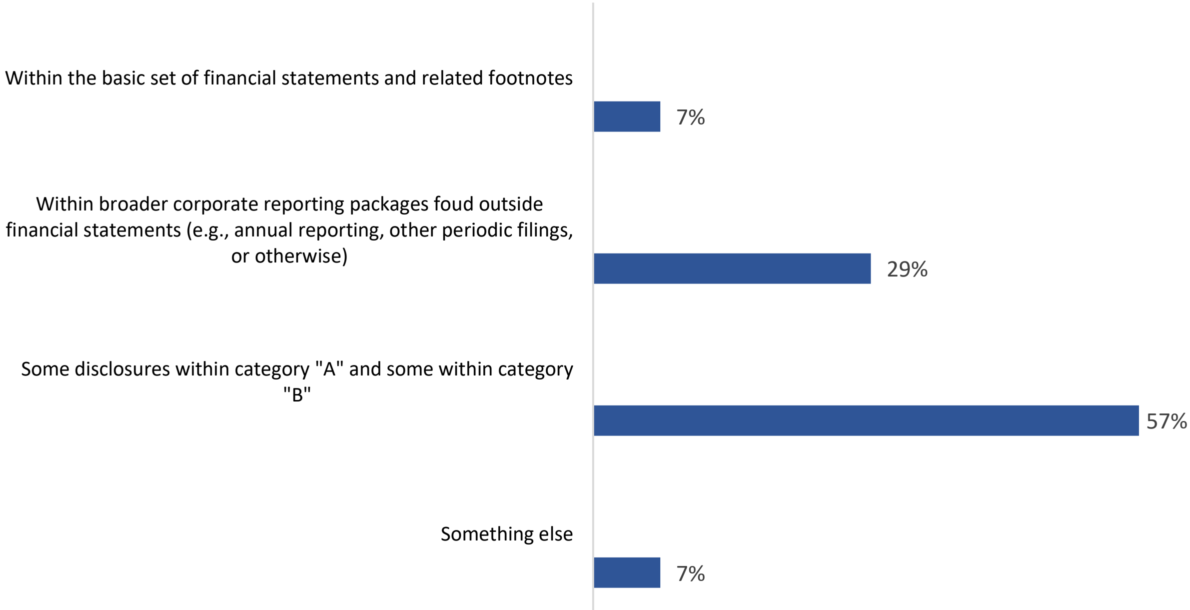
Americas roundtable

Appendix B: Quantified responses to Probing Questions

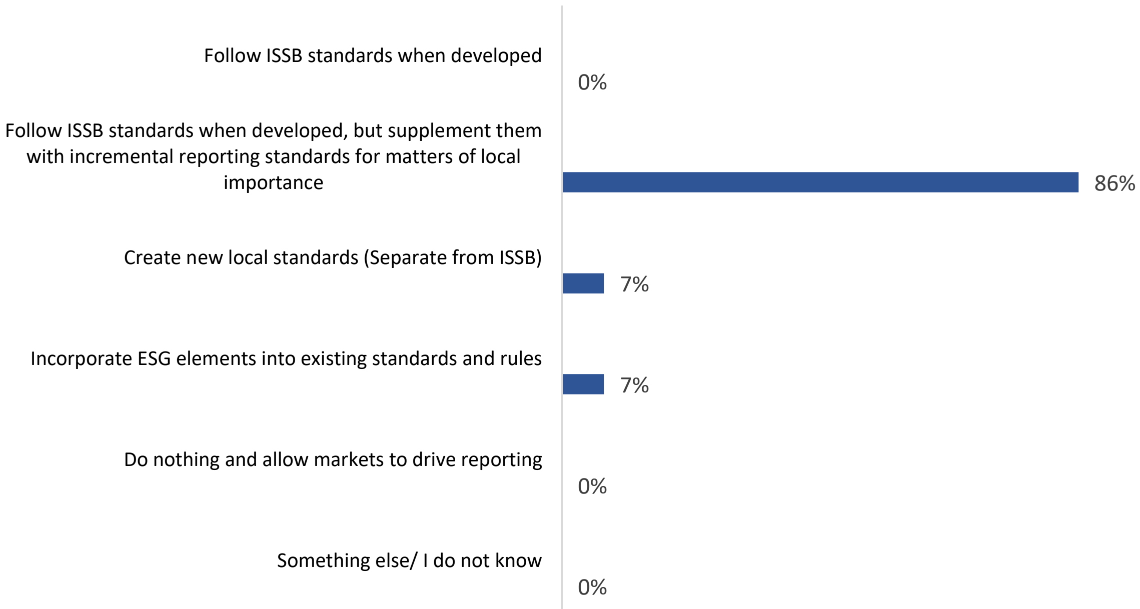
During the discussion, a number of probing questions were asked to catalyse debate. The results are below. These reflect the views of participants at the start of each discussion section. They are not purported to be representative of wider stakeholder opinion, nor opinion once informed by the discussion. They are included here for completeness. Participants did not have to answer every question; and in most cases could select more than one option.

<u>Probing question 1:</u>
What do you believe is driving the gap between what investors and others expect companies to present in their financial statements regarding climate risks and the information that is currently being presented? Select all that apply.

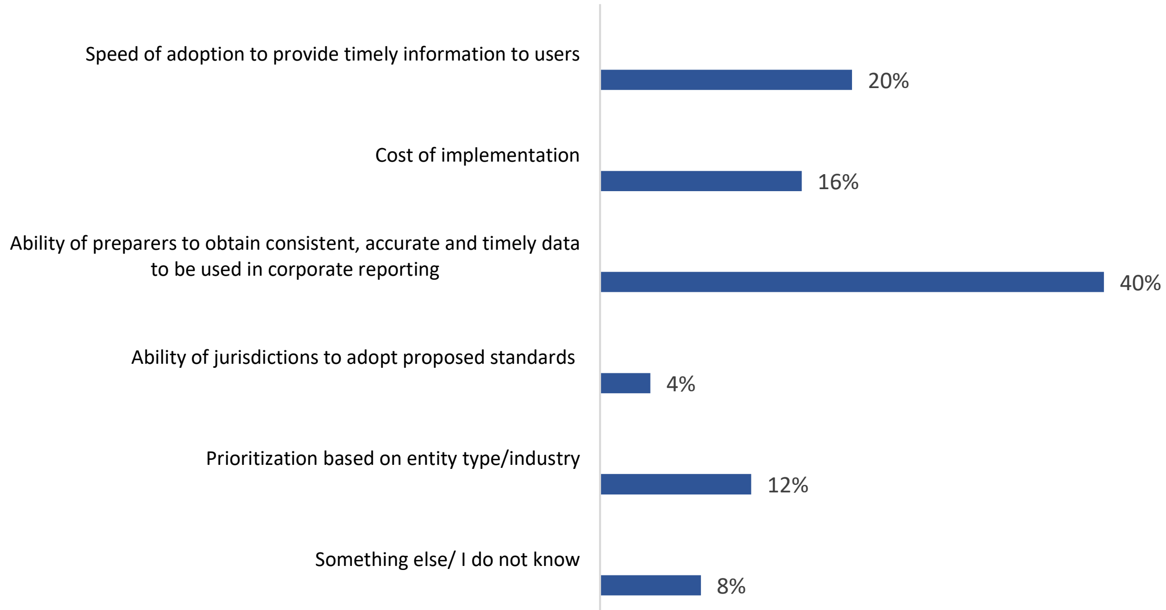
<u>Probing question 2:</u>
Where do you think companies should report ESG disclosures?



<u>Probing question 3:</u>
Which approach do you believe should be adopted for corporate reporting around ESG matters?



<u>Probing question 4:</u>
What factors do you believe standard setters and regulators should consider when developing reporting requirements specific to ESGs? Select all that apply.



<u>Probing question 5:</u>
What do you consider the major obstacles to the reporting and use of ESG information? Select all that apply:

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<u>Probing question 6:</u>
Other than changing ESG corporate reporting standards, what actions do you believe should be taken to help companies meet their sustainability goals and address investors' needs?

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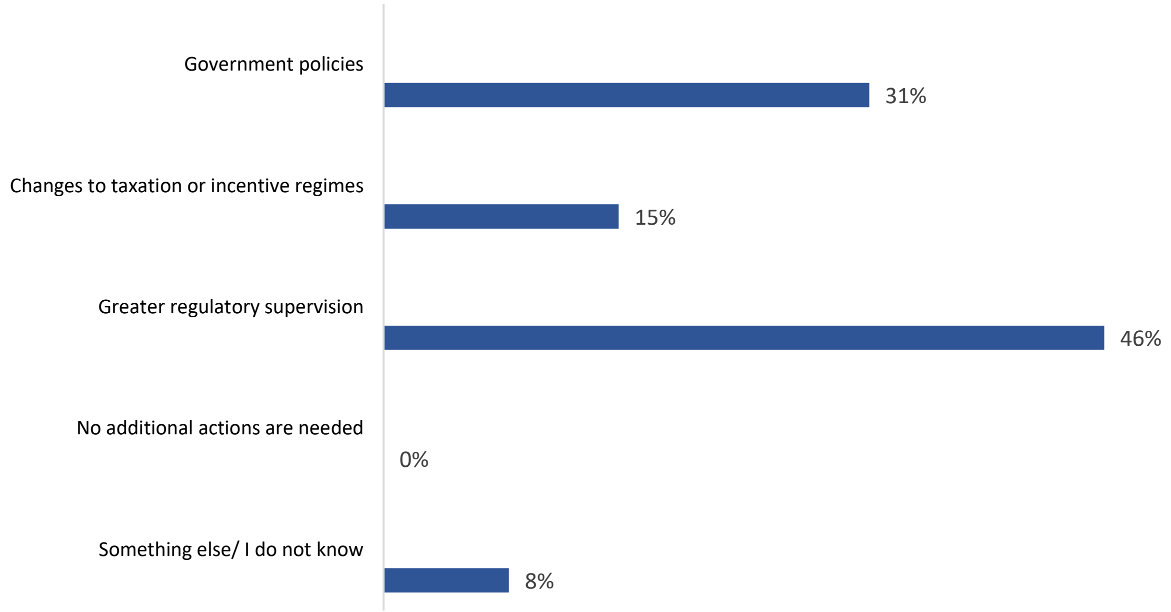
Government policies
31%
Changes to taxation or incentive regimes
15%
Greater regulatory supervision
46%
No additional actions are needed
0%
Something else/ I do not know
8%