Perspectives on ESG Reporting

Japan roundtable -- The future of ESG reporting explored

On Thursday, December 2, 2021, the GPPC[1] brought together 17 stakeholders representing various groups in the corporate reporting ecosystem[2] to explore Environmental, Social, and Governance (ESG) corporate reporting and assurance of the future. Individuals from Japan and other countries in the Asia-Pacific region, including Singapore, Hong Kong, and Malaysia were invited based on their knowledge and expertise on ESG reporting and assurance matters. The roundtable was conducted virtually with technical operation based in Tokyo.

The Japan 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 between what is desired and what is delivered, with a focus on climate

1.1 Many participants expressed that more needs to be done to capture climate related risks

Several participants across categories commented on the slow pace of companies' climate risk assessments and climate-related disclosures in the region citing a number of contributing factors, including a lack of talent and knowledge within the corporate and audit communities necessary to understand complex and often highly-scientific data and prepare and assure reports in accordance with a number of different reporting frameworks; no real incentives for disclosure either in terms of regulatory compulsion or tangible financial gain; and in some instances, clear disincentives such as liability for misinformation reported in the context of a company's financial statements. One

[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] [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.

company/business organization participant noted the absence of well-recognized methodologies for reporting climate-related risks and opportunities, while others acknowledged the fundamental disagreements of what information should be disclosed (i.e. what is material) and where (e.g. integrated report, annual securities report, sustainability report, etc). Importantly, large, multinational corporations seemingly have been quicker to incorporate certain climate-related disclosures into their reporting compared to small- and medium-sized entities (SMEs) in the region, given the greater number of resources larger entities are able to devote to financial reporting, more generally. However, regardless of size, participants of the roundtable agreed that generating *quality* reporting of ESG information remains a formidable challenge.

> *"Unless there is a regulatory requirement, or an 'invisible hand of God' that's directing disclosures, or very clear, tangible financial benefits – either through customers or employees – a lot of companies, particularly the small to mid-cap companies, will ask why? What am I getting from these disclosures?"*
>
> *TCWG*

1.2 There is a difference of opinion about the cause of the current gap in financial reporting: What investors are expecting and what companies are delivering

Companies and standard-setters need more time to adapt

One investor/investor associations participant observed that the trend toward sustainable investing and sustainability reporting is moving at extraordinary speed. For example, as recently as 2018 when the IASB was considering updates to the practice statement in the management commentary, the IASB did not have resources or technical expertise on matters of non-financial reporting, and in fact, did not believe sustainability issues belonged in the scope of financial reporting within the management commentary. Fast forward to the current IASB exposure draft on the same topic, and the recommendations now include requiring that sustainability issues be addressed in the management commentary. In addition, the participant noted, the IASB continues to build out its capacity to address ESG-related accounting in its standards.

Another TCWG participant drew attention to the maturity continuum across the region, and indeed, across industries, noting that some country responses to climate change are still *"in the early stages."* Many economies are driven by fossil fuels and plantations which are highly-climate sensitive – these sectors are naturally more reluctant to address climate risk. The financial sector, however, has made some progress.

On the other hand, one investor/investor association participant rejected the argument outright that more time is needed for companies to prepare assessments and disclose climate risks, firmly believing that the IASB has made it clear that climate risk is a material economic risk like any other and thus, is subject to the same disclosure requirements.

> *"We've been talking about this for a long time – we're six years out from the Paris agreement. It's hard to see … What more signal is required, from government, from society, from the financial system that this is a material issue?"*
>
> *Investor and investor associations*

Disagreement on materiality
While many agreed that the current rules and standards are outdated and need to be refreshed to allow for quality climate-risk reporting, others believe that the primary driver of the gap between what companies are reporting and what investors are seeking is a fundamental disagreement over what is material.

"I cannot believe that companies and auditors would be signing off on accounts that did not include this as a risk unless they had this view already, that climate was not a material risk to their business. And that, I guess, is where the frustration is being felt. Investors are saying this is material to our investment decision-making, but companies are saying, 'Well, our best judgment and the judgment of our accountants and our auditors, is that this is not material to our financial statements.'"

Investor and investor associations

Required vs desired
Some participants suggested that the accounting standards themselves may be driving the gap in investor expectations and climate-risk reporting – both from a corporate reporting perspective and an audit perspective. For example, one assurer/professional body participant noted that IFRS 36 requires that companies record impairment losses based on fair value less cost to sell or value in use. However, these estimates are based on current conditions and do not allow for consideration of future restructuring; likewise, future cash flows are based on recent budget projections; from there, extrapolation is needed. Auditors look carefully at the accounting requirements and standards to determine if the financial statements were prepared fairly and accurately and conduct their audits in accordance with IAASB standards. As such, while their reports may reflect the opinion that the accounting has been applied appropriately under current standards, future risks may not be necessarily captured in the manner which investors desire.

This view was summed up by one participant who emphasized that current financial reporting accounting standards are based on historical numbers. The expectation gap is that investors and asset managers are much more interested in targets and future performance.

"While we're talking about reporting, if we're just looking at the historical performance and figures without targets that have been set and the metrics on reaching those targets, that is really critical."

Investors and investor associations

2. **Where we should go:** Desired features of corporate reporting and assurance of the future

2.1. ESG Reporting should be tailored based on the stakeholder audience

There was wide agreement among participants that there exists a multitude of diverse stakeholders with varying interests in ESG-related information. Thus, disclosures should be packaged in different ways and may differ in terms of content and detail based on the audience. However, the majority of participants agreed that material information should be reflected in reports that contain audited

financial statements, whereas certain, forward-looking information such as that currently reported under the GRI framework could remain in a company's sustainability reports or other non-financial reports.

> *"You must have material ESG information in the annual report because it is actually a part of a well- functioning company. A company that is functioning well will be managing and will be monitoring both its key risks and opportunities."*
>
> *Investors and investor associations*

Within the discussion of where ESG information should be reported, the concept of materiality was once again on the forefront. One investor/investor association participant noted that materiality considerations should not be limited to material topics but also need to include material entities and ensuring that the boundary is properly scoped to encompass all business practices and entities relevant to the material topics. Another described the investor/asset manager community's interest in companies' potential for future growth, aspects of which are indeed material and should be reflected in the annual financial report. Investors and asset managers look for a "good track record" of incorporating future risk and opportunities in reporting, focusing on such calculations as revenue from climate change solutions and revenue targets for related business segments. This record can be demonstrated in the context of annual financial reporting and recorded in accordance with existing accounting standards.

2.2 Timeliness of reports

In addition to where ESG information should be reported, several participants commented on the timeliness of the reports necessary to provide optimal benefit to investors. For the ESG information most material to a company's financial reporting, investor/investor association participants opined that investors need that information in advance of the Annual General Meeting (AGM) of shareholders. Not only does a company's timely ESG reporting send a signal to shareholders that management firmly believes sustainability issues are integral to the company's current and future state, but it also provides shareholders leverage for holding Corporate Boards accountable. If sustainability and future targets are not being met, shareholders have the ability to vote Directors out.

2.3. The role of assurance

Despite certain challenges facing the assurers of ESG reporting, several participants across a broad spectrum of the reporting ecosystem agreed that assurance over the most material ESG information is essential to provide confidence and promote reliability and fairness of the data. With respect to climate (and more broadly the "E" of ESG), the reporting of figures such as carbon pricing and greenhouse gas (GHG) emissions should be assured as they have become embedded in the financial markets. Outside of the "E", one company/business organization participant noted that assurers need to expand the coverage of what they are assuring to include human capital data, an element essential to creating corporate value.

3. How to achieve the desired future state

3.1. Addressing the "policy vacuum"

In response to questions dealing with actions toward attaining the desired environment for ESG reporting, an overwhelming number of respondents cited a lack of government policies in the ESG space on both the corporate reporting and assurance fronts. As noted previously in reference to the current state of ESG reporting, companies lack clear incentives to report ESG information either from a business compliance perspective or in tangible financial gains. In many jurisdictions, ESG disclosures are still voluntary which has a limiting effect because corporates will only disclose information with which they feel intrinsically comfortable. This also limits the scope of any assurance services provided.

One participant highlighted the fundamental issue of externalities such as environmental pollution and climate change to demonstrate the void of coherent policies:

> *"Financial reporting today is simply not equipped to deal with externalities.[4]"*
>
> *"Climate change is a huge externality. Unless we define who is the 'agent,' who should pay, it's not unreasonable for issuers and auditors to struggle."*

Investors and investor associations

Assurance should be mandatory for material ESG disclosures.

Another investor/investor association participant lamented the lack of policies regarding the assurance of ESG information, pointing out that audit firms struggle with decisions to invest in the skillset and talent pipeline needed to provide quality assurance, absent a predictable demand for the service. Ultimately, that demand is driven by regulatory mandate or lack, thereof.

The same participant remarked that policymakers could actively work toward an accreditation system for certifying or qualifying auditors to provide the necessary assurance services, beginning with the creation of a core skillset. Such a measure, the participant concluded, would give assurers confidence in conducting assurance services and delivering the reports and give investors the confidence that the reports are reliable.

3.2 Collecting and understanding quality data – Cultivating talent and building skillsets

When asked about the major obstacles to quality ESG reporting, several respondents agreed that collecting and understanding data at all points of the value chain is complex, costly, and overall difficult to achieve, as is the establishment of systems of quality control and internal controls over the collection of the data. One assurer/professional body participant expanded upon this notion, emphasizing the need to improve tools and systems to collect and to audit ESG data, and to build the knowledge and skillsets across the entire reporting ecosystem. Currently, there are a limited number of company leaders, including CFOs, who are well-versed in environmental management and regulations and a limited number of sustainability experts who can integrate ESG information into accounting from a financial perspective.

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[4] The participant defined an "externality" as consequence of an action that affects someone else other than the agent undertaking that action and for which the agent is neither compensated nor penalized.

"We are needed to cultivate leaders who can bridge between financial and traditional business management as well as sustainability and who can incorporate the social aspect – while building relationships with various stakeholders. So it is necessary to develop human resources with the skillsets to integrate the two fields."

Assurers and professional bodies

Likewise, the quality of assurance services is dependent on the quality of the management system of the firm providing the assurance. A TCWG participant emphasized this point, adding that professional skepticism needs to be embedded in the skillset of ESG assurance providers, in addition to knowledge and expertise on a broad range of subjects, in order to meet investor expectations.

3.3 Some practical steps forward

Global standards

While many participants commented on specific aspects of current reporting and auditing standards which fall short of what is needed to provide meaningful information to stakeholders, there was a clear collective view that one set of global standards is essential to achieving the desired state of ESG reporting and assurance (with allowances for addressing local circumstances and requirements of specific sectors). Likewise, many expressed clear support for the creation and direction of the International Sustainability Standards Board (ISSB) as the body to take this objective forward, with one participant applauding the ISSB's absorption of talent and expertise of the Value Reporting Foundation (VRF).

" I welcome the direction that the ISSB seems to be going … the ISSB and IASB seems to be very much investor-focused with integrated reporting at its core."

Companies and business organizations

Making a start -- a whole of ecosystem approach

To summarize what should be the focus in the near-term while awaiting the more systemic policy, regulatory and standards-related changes, one person characterized the goal of ESG-reporting as follows:

"What we're trying to answer is one simple question – to what extent is ESG a core component of the strategy of a company rather than just the compliance of a company?"

--- *Investors and investor associations*

Companies can demonstrate that they take ESG concepts seriously through the reporting – providing answers to questions related to the extent of board involvement, how ESG is built into a company's Enterprise Risk Management (ERM) framework and procurement systems. Fundamentally, *"Do we want to embed this in the heart of our business?"* Addressing elements of comparability and consistency can be addressed once this core question is answered.

With respect to auditing, with the understanding that building skills and talent will take time, one investor/investor association participant remarked that auditors should have some built-in flexibility

to start assuring a smaller scope of material aspects and entities, and then expand upon that scope as they further develop their teams and resources.

And finally, from the perspective of boards of directors, one TCWG participant observed that reporting is disproportionately focused on compliance and risk-management as opposed to helping drive company performance or plan for the company's future. This disparity needs to change over time. However, while imperfections may always exist, we must– *"let perfection not be the enemy of the good."* This participant encouraged companies to "*Start disclosing something and incorporating with your management systems*" believing that the quality of reporting can be improved over time.

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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

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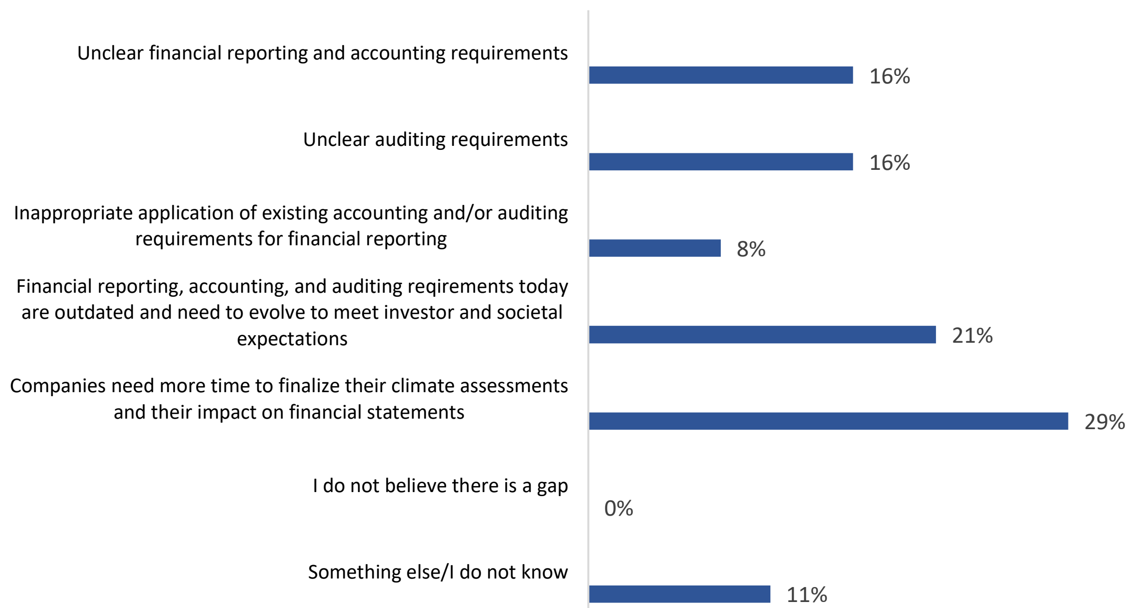
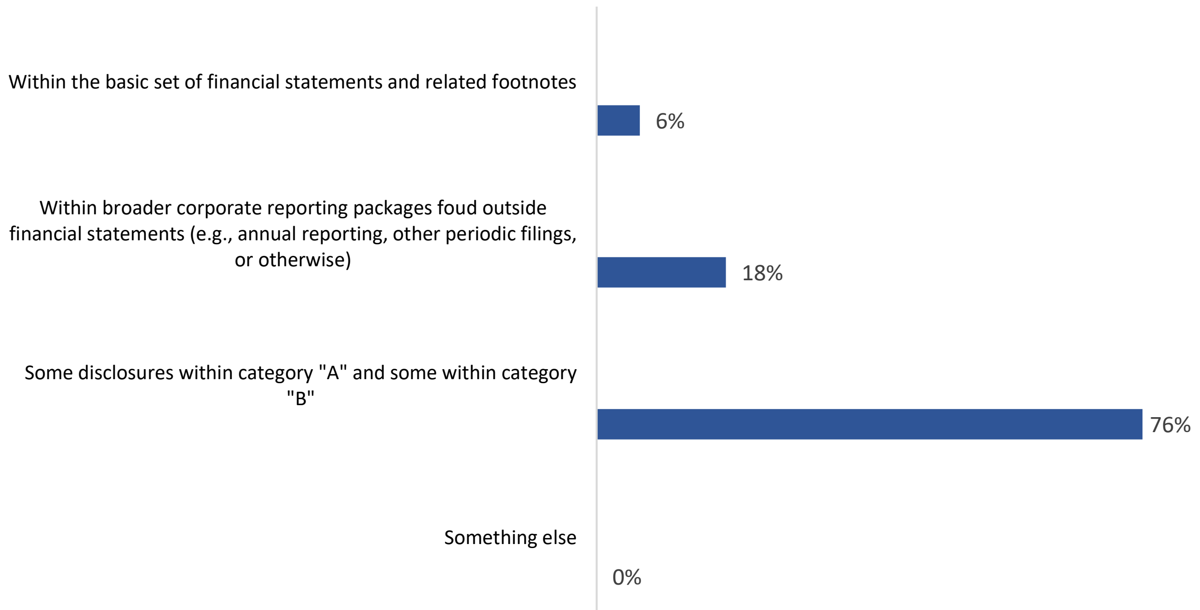
Appendix B: Quantified responses

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.

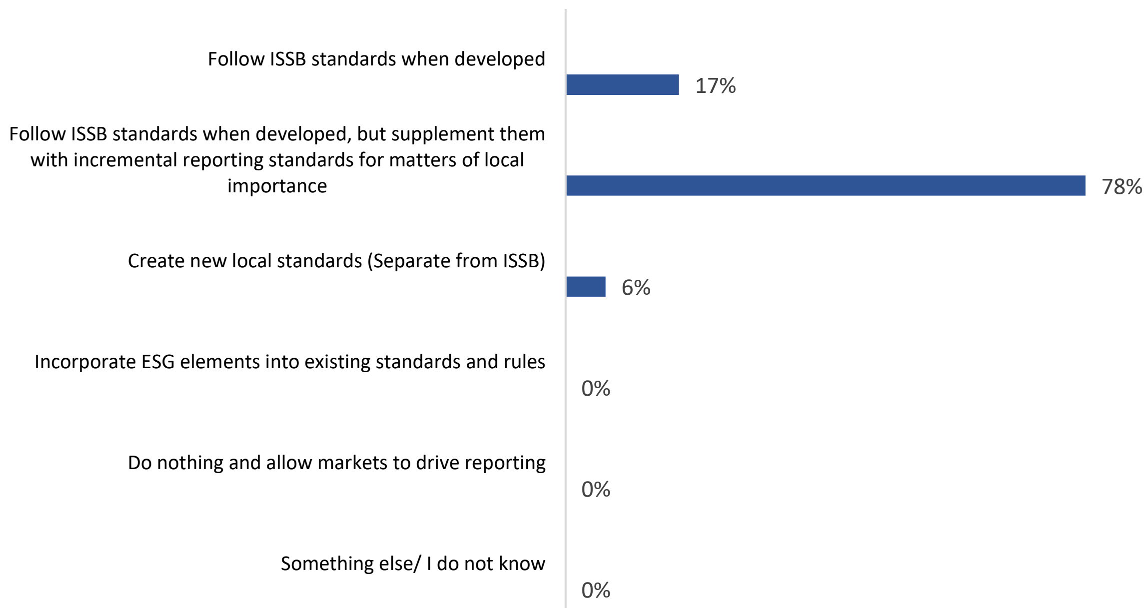


<u>Probing question 2:</u>
Where do you think companies should report ESG disclosures?



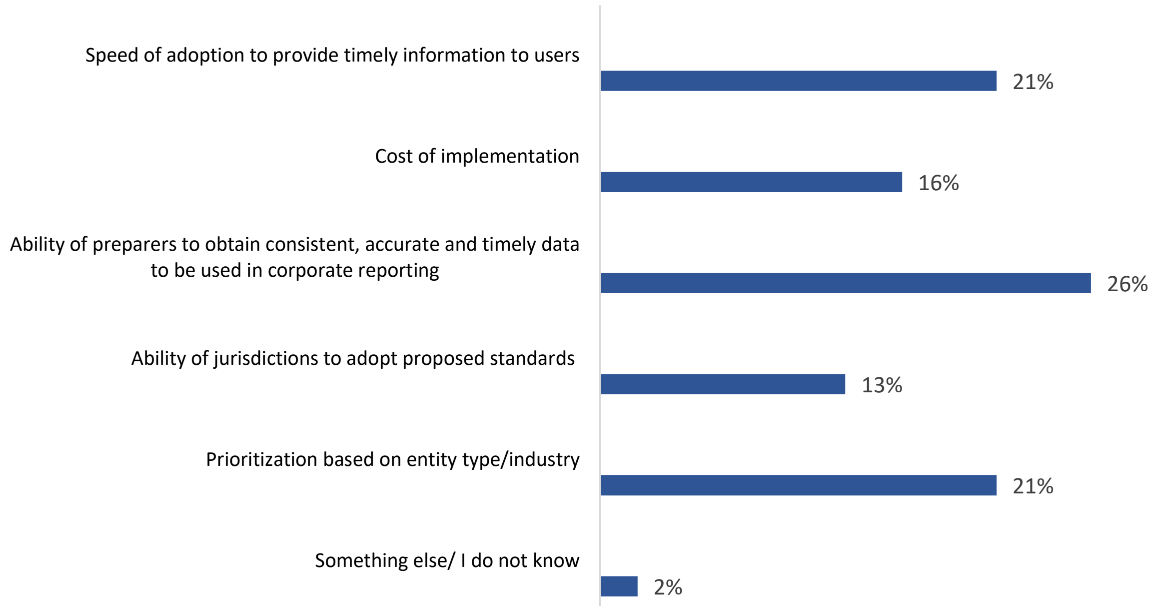
Probing question 3:

Which approach do you believe should be adopted for corporate reporting around ESG matters?



Probing question 4:

What factors do you believe standard setters and regulators should consider when developing reporting requirements specific to ESGs? Select all that apply.



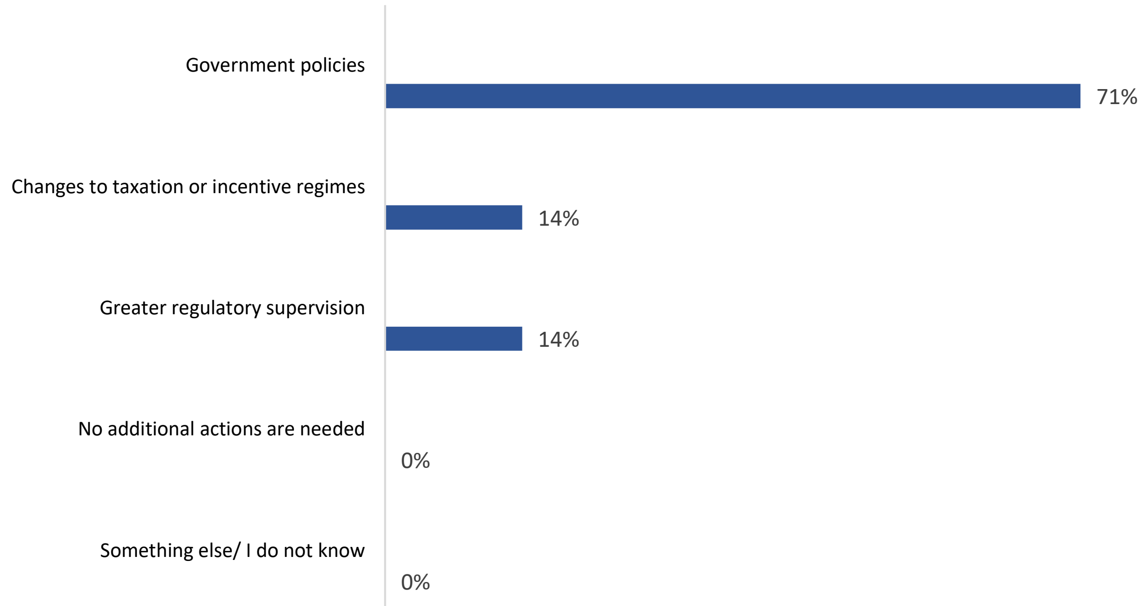
Probing question 5:

What do you consider the major obstacles to the reporting and use of ESG information? Select all that apply:

Probing question 6:

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?

GPPC


Government policies
71%
Changes to taxation or incentive regimes
14%
Greater regulatory supervision
14%
No additional actions are needed
0%
Something else/ I do not know
0%