Investors and stakeholders want ESG information

Articulate your plans and progress

Environmental, social and governance (ESG) activities challenge companies to find ways to grow their businesses and reward investors while addressing essential issues that could affect their near- and long-term success.

Read on to explore the trends driving companies to implement sustainability reporting. You'll find an overview of developments among standard setters and regulators, and considerations for preparing to implement or update your sustainability reporting.

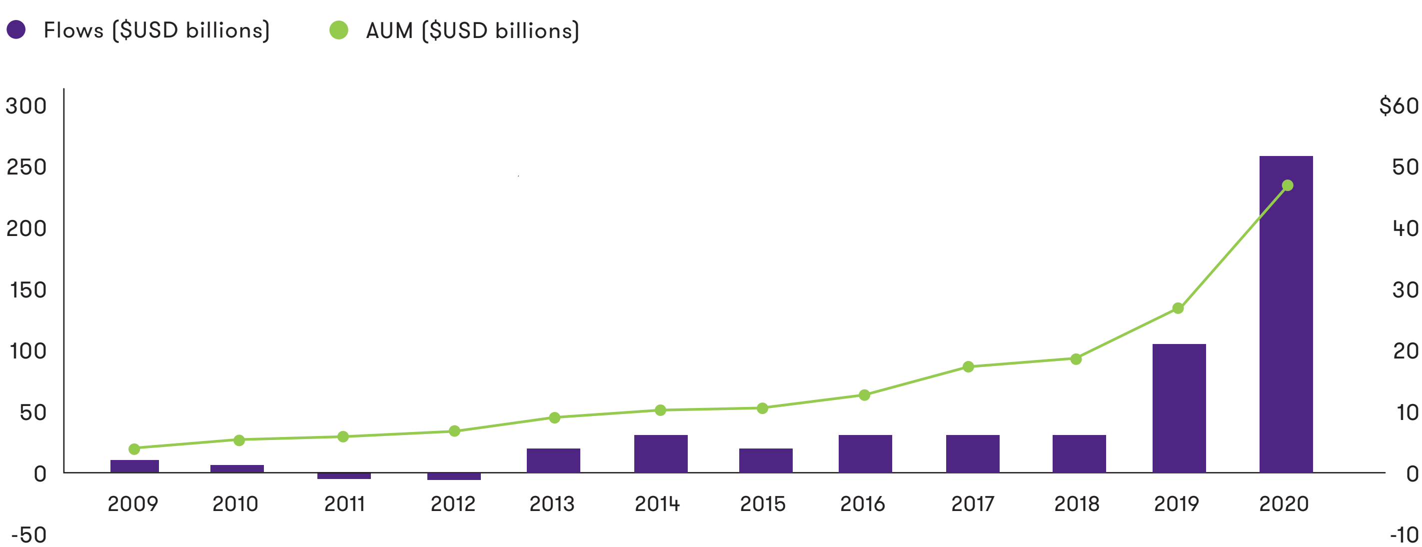
Investors push for progress

Asset managers and shareholders have made it clear — ESG factors are important drivers of long-term value. BlackRock, the largest asset manager in the world, states in its Engagement Priorities for 2021: "Our conviction is that companies perform better when they are deliberate about their roles in society and act in the interests of their employees, customers, communities and shareholders. We use our voice as a shareholder to urge companies to focus on important issues, like climate change, the fair treatment of workers, and racial and gender equality, as we believe that leads to durable corporate profitability."

This is not about public relations; the inclusion of ESG factors in investment strategies and decisions is rising, following studies consistently demonstrating the correlation between good management of ESG issues and positive returns. According to the US SIF Foundation, an association advancing sustainable investing, total U.S.-domiciled assets under management using sustainable investing strategies were $17.1 trillion at the beginning of 2020, representing 33% of such assets. Given the adoption of ESG or sustainability factors into asset management strategies, it appears sustainable investing is here to stay.

State Street Global Advisors, the fourth largest asset manager globally, has stated, "Climate change has been a core theme of State Street Global Advisors stewardship activities since 2014." Further, the multinational financial services firm, Carlyle Group has made it its policy to include ESG integration as a core goal in building better businesses around the world. During February 2021, as a sign of its commitment to ESG matters, the Carlyle Group announced it had secured the largest ESG-linked private equity credit facility in the U.S. The credit facility is the first of its kind to focus exclusively on advancing board diversity and tying the price of debt directly to its goal of having 30% diverse directors on boards of Carlyle-controlled companies within two years of ownership.

Sustainable funds – annual flows and assets



Source: Morningstar. Data as of 12/31/2020
Includes sustainable funds as defined in Sustainable Funds U.S. Landscape report, Feb.2020.
Includes funds that have been liquidited; does not include funds of funds.

Retail investors also show strong support for sustainability-focused investments, with the flow of capital into sustainable funds growing at a rapid pace. During 2020 alone, net flows into sustainable open-end and exchange-traded funds available to U.S. investors more than doubled year-over-year when they reached $51.1 billion and made up nearly one-fourth of overall net flows into stock and bond mutual funds in the U.S.

Executives are also paying attention to ESG investing trends. In a 2020 McKinsey Global Survey on valuing ESG programs, 83% of C-suite leaders and investment professionals were noted as expecting that in five years, ESG programs would contribute more shareholder value than they do today. Survey results indicated that C-suite leaders and investment professionals would be willing to "pay about a 10% median premium to acquire a company with a positive record for ESG issues over one with a negative record." For acquisitive companies, ESG considerations may well play into the valuation of potential target companies or, for companies looking to be acquired, may serve as a point of reference to maximize exit value.

Consequences of inaction

Proxy voting guidelines

Asset managers have been a driving force in recent ESG reporting trends. They have demanded action by investees, who stand to face the consequences of ignoring such calls. In January 2020, BlackRock announced that it expects the companies it invests in to conform their disclosures to the recommendations of the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosure (TCFD). BlackRock also indicated that the absence of such disclosures could be viewed as a failure by an investee to properly manage risk.

In addition, BlackRock stated, the asset manager will, in some cases, use its proxy voting power to encourage companies to comply with these disclosure standards. State Street Global Advisors has also announced it will use its proxy voting power against board members of certain companies that are falling behind in their ESG rating and have not demonstrated plans to improve this rating. Other large financial services firms have made similar announcements.

This sentiment has gained momentum, as indicated by the following statement from Goldman Sachs Asset Management's Stewardship Report of 2020.

"GSAM defines stewardship as the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society. We are continually evaluating companies' corporate strategies, investment and financing activities, management incentives, resource use, regulatory policies and environmental impact, as well as overall effect on and engagement with consumers, workers, and the communities in which they operate to assess and promote long-term value creation. In this manner, assessing and promoting effective stewardship is a key part of our investment process."

Public companies listed in the United States are required to file an annual proxy statement that includes resolutions put to a shareholder vote. Common voting matters include the election of board members and whether to support recommendations for executive compensation. Boards and executives face pressure to keep ahead of proxy voting guidelines published annually by proxy advisory firms or risk investors being advised to vote against proxy resolutions supported by the board and management.

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It is important to understand the role of proxy advisers and how they may influence the success of matters put forward for a shareholder vote. Because a substantial portion of the U.S. public equity markets are held by institutional investors, such as pensions and mutual fund managers, proxy advisors have significant influence on whether a resolution put to a vote is successful or not. The level of effort involved in evaluating multiple resolutions per investee across a large portfolio of companies and the SEC's requirement for registered institutional investors to develop and disclose their proxy voting policies drive many institutional investors to rely on the proxy voting guidelines from proxy advisers. These guidelines are developed through an extensive process of independent research, as well as feedback and input from investors and companies, and are published annually in advance of proxy voting season.

While proxy advisers provide guidance on a broad array of issues, ESG matters have received increased attention. For example, in its 2021 proxy voting guidelines, Glass Lewis noted:

"In situations where we believe that a company has not properly managed or mitigated environmental or social risks to the detriment of shareholder value, or when such mismanagement has threatened shareholder value, Glass Lewis may recommend that shareholders vote against the members of the board who are responsible for oversight of environmental and social risks."

Grant Thornton's ESG and Sustainability Services Partner Jim Burton advised leaders to expand beyond awareness: "Board members and executives are increasingly expected to not only engage on ESG issues but also provide transparent disclosure regarding the company's strategies, goals and progress in managing ESG risks and opportunities."

Developments in sustainability reporting

While it is clear investors are asking for actionable information for use in investment and voting decisions, it can be difficult to determine what and how to report. Sustainability and ESG reporting is not mandated by any regulatory requirement in the United States.

While many large companies provide voluntary sustainability or corporate social responsibility reports, they are free to select from a variety of standards, including those of the SASB, Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC) and the TCFD. Some companies disregard disclosure standards and frameworks altogether and report using metrics self-identified as important to their business. The lack of standardized requirements results in inconsistency and incomparability in publicly reported ESG information, a common complaint among investors.

However, the fragmented ESG reporting landscape is rapidly transforming. Companies should pay attention to regulatory developments so they're prepared to meet potential future requirements. The Biden administration has exhibited enthusiasm for climate-smart regulations within its whole-of-government approach to climate change, and the SEC is well-positioned to take a central role in maturing America's regulatory regime. The agency has recently announced several developments related to climate and ESG risks and opportunities. While these initiatives began under the leadership of then-Acting SEC Chair Allison Herren Lee, the SEC is expected to remain focused on climate change and ESG matters under Chairman Gary Gensler, who was sworn in during April.

In light of growing public demand for climate change disclosure, Lee requested public input from investors, registrants and other market participants on developing new disclosure requirements. In a speech before the Center for American Progress, the then acting Chair noted, "It's time to move from the question of 'if' to the more difficult question of 'how' we obtain disclosure on climate." During his Senate confirmation hearing, Gensler indicated investors are looking for more climate risk disclosure and issuers could benefit from disclosure standardization and guidance. While any incremental disclosure requirements would take some time to undergo the SEC rulemaking process, registrants should pay attention to current disclosure requirements today.

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> **Jim Burton, Partner**
> **ESG and Sustainability Services, Grant Thornton**

Perhaps of most immediate consequence to current SEC registrants, Lee issued a statement directing the SEC's Division of Corporation Finance (CorpFin) to enhance its focus on climate-related disclosures. CorpFin is tasked with reviewing how public companies are currently applying the 2010 Guidance Regarding Disclosure Related to Climate Change and will use insights learned to update that guidance. Companies may soon, during the course of routine filing reviews, receive comments regarding compliance with the climate change disclosure guidance.

"Many of the disclosure considerations identified in the 2010 guidance remain relevant today. Registrants should review their disclosures against the guidance and current Regulation S-K requirements to proactively address any gaps in disclosure." Marjorie Whittaker, Managing Director, SEC Regulatory Matters

For more details on the SEC's focus on climate and ESG, including an overview of the climate change disclosure guidance and existing disclosure requirements, read Snapshot 2021-09, "SEC undertakes climate and ESG-related activity."

As U.S. regulatory bodies progress toward requiring standardized climate and ESG disclosures, they are poised to enter a complex international schema featuring numerous inconsistent, incomparable reporting frameworks. In its September 2020 *Consultation Paper on Sustainability Reporting*, the IFRS Foundation stated that "the potential of fragmentation and the growing demands from stakeholders demonstrate the need for a global framework to provide greater comparability and reduce the complexity of approaches and objectives."
To achieve coherence and comparability, the Foundation proposed creating a new Sustainability Standards Board to develop and maintain a set of global sustainability standards focused initially on climate risk. Feedback to the 2020 consultation confirmed an urgent need for global sustainability reporting standards and support for the Foundation to play a role in their development. As announced in March 2021, the IFRS Foundation Trustees are continuing their work to potentially establish an international sustainability reporting standards board within the existing governance structure of the IFRS Foundation.

Other major standard setters have similarly made a collective effort toward ameliorating the complexity surrounding sustainability disclosures.

In September 2020, five major global reporting organizations — the CDP (formerly the Carbon Disclosure Project), the Climate Disclosure Standards Board, the GRI, the IIRC and the SASB — filed a joint statement of intent to work collaboratively toward a global sustainability standard-setting framework. These five framework- and standard-setting institutions have co-published a shared vision of the elements necessary for more comprehensive corporate reporting and a joint statement of intent to drive toward this goal by working together and committing to engage with key actors, including International Organization of Securities Commissions and the IFRS Foundation, the European Commission and the World Economic Forum's International Business Council. In late 2020 the group issued a paper providing more details on how their frameworks and standards could be used as the starting point for global sustainability reporting standards.

"Looking toward the future, American executives and regulators would do well to heed these signals of fast-approaching regulatory trends for U.S. companies," said Grant Thornton's Jim Burton. "If disparate disclosure standards are mandated around the globe, multinational corporations may soon face the daunting task of implementing and reporting against a variety of ESG disclosure standards on a jurisdiction-by-jurisdiction basis."

Action steps for your company

With so much in development, it can be difficult to figure out where to start. While disclosure of most ESG information is not yet compulsory, market forces and a shifting regulatory climate suggest that ESG reporting may not remain voluntary for long.

By establishing ESG reporting capabilities and initiatives now, your company will be prepared to meet the demands of key stakeholders, investors and external regulators. This cannot be accomplished without the engagement of senior leadership. ESG issues must be a focus of those who drive strategy and make capital-allocation decisions.

"It is apparent that an ESG transformation renaissance is approaching," observed Angela Jhanji, Grant Thornton director of ESG & Sustainability Services. "We continue to hear 'So what's next?' from our clients, who have adequately maneuvered their disclosure. Thinking two or three levels down from compliance, executives are starting to explore what this data means for business performance and how to communicate about risks and opportunities with their stakeholders and shareholders."

Consider these implementation strategies

- **Leverage strengths.** Identify your brand attributes and current drivers of value creation, then tie sustainability metrics to the traits you are already known for. Integrating sustainability metrics into your core business will be more meaningful for customers and reinforce the strength of your brand. While reinforcing your brand image can be a value driver, review your disclosures to ensure they are balanced and address both the progress being made and areas of improvement.
- **Utilize benchmarking analysis.** Examine the sustainability information shared by your competitors and the method of its dissemination. Peer disclosure practices shape the expectations of shareholders. Disclosures are more useful when they are comparable across an industry, and benchmarking analysis can help ensure you are providing decision-useful information. Consider how ESG ratings agencies grade your performance and look for opportunities to improve your performance or better explain to the market the progress your company is making.
- **Select an appropriate reporting framework.** Numerous sustainability reporting frameworks exist, and while there is momentum toward converged standards, those efforts may take years, if they come to fruition. In the meantime, you could utilize one or more of the existing disclosure frameworks or standards. For example, some companies have used a combination of GRI and SASB standards. GRI standards focus on the impact ESG issues have on society and the environment, while SASB standards emphasize the relationship between ESG measures and financial performance. And as discussed, your company might have an investor mandate to implement certain standards (SASB, TCFD).
- **Identify material sustainability issues.** The sheer number of ESG issues can seem overwhelming. By focusing on the subset most material to your company, you can achieve meaningful results and add value for your stakeholders. A helpful reference tool may be the SASB materiality map, which identifies, by industry, the ESG issues most likely to have a material financial impact. Even if your company does not report on each ESG issue, identifying one or two material ESG areas of initial focus can be enough to gain momentum.
- **Pinpoint gaps in currently available data.** Because many sustainability metrics are tied to long-term value creation, many companies will find that they already track information similar or identical to ESG metrics. This data can be leveraged to prepare external disclosures. In cases where no reporting process exists, consultation with sustainability experts may be necessary to establish a baseline and implement a tracking process.
- **Ensure your data is accurate.** As sustainability data attracts increased scrutiny, internal controls over reporting are critical. The Committee of Sponsoring Organizations of the Treadway Commission's Internal Control — Integrated Framework is already widely used for financial reporting and can be utilized with sustainability reporting, as well. For U.S. Listed entities, sustainability information reported in Exchange Act reports filed with the SEC is subject to disclosure controls and procedures.

Obtain external assurance over your disclosures

Maximize the impact of your sustainability information by obtaining external verification. Not only will assurance provide a level of trust, but also you'll differentiate your company from competitors. The objectivity of third-party assurance is essential to building credibility and avoiding suspicion of "greenwashing" — the selective disclosure of information that paints the subject company in a more favorable light than may be warranted. An additional benefit is that independent assurance can help audit committees assess the quality of ESG disclosures.

For more on what your organization can do to prepare for future climate change, see "Climate risk trends call for informed action."

Contacts

Jim Burton
Partner
ESG & Sustainability Services
Grant Thornton LLP
T +1 303 813 3945
E Jim.Burton@us.gt.com

Angela Jhanji
Director
ESG & Sustainability Services
Grant Thornton LLP
T +1 202 250 0463
E angela.jhanji@us.gt.com

Marjorie Whittaker
Managing Director
SEC Regulatory Matters
Grant Thornton LLP
T +1 202 521 1535
E marjorie.whittaker@us.gt.com