GLASS LEWIS

Sustainability Reporting

In-Depth Report

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Introduction

Issues related to sustainability represent the new frontier in corporate reporting. Broadly defined, sustainability reporting includes a company's impacts, risks, and opportunities from an environmental, social, and governance ("ESG") perspective. The increasing focus on sustainability-related issues has caused even mainstream investors to question whether companies are effectively addressing the risks posed by their operational impact on the environment and society. According to a 2018 Ernst & Young survey, 97% of investors say they conduct either an informal or a structured methodical evaluation of a company's nonfinancial disclosures. In late 2023, a report identified $30.3 trillion globally in sustainable investment assets under management. In non-U.S. markets, sustainable investment assets under management have increased by 20% since 2020. Meanwhile, as of 2022, the United States had $8.4 trillion in total sustainable investment assets under management (p.5).

It is, therefore, unsurprising that more investors have pressed companies to produce sustainability reports that accurately depict how they manage and address sustainability concerns. In response, companies have increasingly emphasized the importance of sustainability by adopting new initiatives and providing the requested disclosure. For example, a 2012 MIT *Sloan Management Review* survey of international executives and managers found that 70% of respondents stated sustainability has a permanent place on the management agenda at their respective companies, and almost none said that they planned to reduce their commitments to sustainability. In a subsequent 2013 survey, 86% of executives reported that they believed that sustainability was necessary for their companies to be competitive in today's market. However, the 2017 survey found that while 90% of executives see sustainability as important, only 60% of companies have a sustainability strategy; of these, only 25% had developed a clear business case for their sustainability efforts. With respect to disclosure itself, the Governance and Accountability Institute reports a significant rise in sustainability reporting, finding 86% of companies in the S&P 500 produced a sustainability report in 2018, up from just 20% in 2011. More recent data shows that 98% of S&P 500 companies and 90% of the Russell 1000 companies were publishing sustainability reports in 2022 (p.5).

According to KPMG's survey of sustainability reporting, nearly all of the world's top 250 companies report on sustainability. In 2022, the rate of reporting among the top 250 companies was at 96%, the same as in 2020. In addition, there has been a significant increase in integrated reporting since 2020, particularly within the Middle East, Latin America, and Asia Pacific region.

Given the growing adoption of sustainability reporting, it is increasingly important that companies not only consider sustainability issues but also communicate their sustainability strategies to investors, and sustainability reports are a key vehicle for communicating this information. However, as companies adapt to rising investor demands through ever more complex forms of sustainability reporting, confusion has arisen over what information to report and the best way to report it.

Sustainability Reporting Regulation and Guidance in the U.S.

For decades, U.S. companies have been required to report on some aspects of sustainability-related issues. For example, in their annual reports, companies must disclose certain legal proceedings arising from employment, safety, or environmental issues if said lawsuits could equal or exceed $100,000 or 10% of a company's assets. In addition, since 1971, the tendency has been to require greater disclosure of details related to environmental, social, and governance issues, such as:

- Details related to environmental liabilities;
- Environmental, administrative, or judicial proceedings;
- Establishment of internal controls to avoid fraud and inaccuracies in the reporting of government regulations and legal proceedings; and
- Guidance related to material risks associated with climate change.

Since Congress passed the *Dodd-Frank Act* in 2010, the Securities and Exchange Commission ("SEC") has required disclosure of issues related to the use of conflict minerals, payments made to foreign governments, and equitable compensation. These mandates have arguably led to more comprehensive reporting of sustainability-related issues. Yet, despite adherence to relevant disclosure requirements, many companies still do not clearly present how they have integrated sustainability into their business models, thereby preventing investors from ascertaining related risks and opportunities. A clear and integrated report is often referred to – and will be referred to here – as a "sustainability report."

While the U.S. government does not currently obligate companies to publish a sustainability report, several federal agencies have promoted stronger requirements and provide guidance to companies regarding sustainability disclosure practices. In 2009, for example, the Environmental Protection Agency ("EPA") established mandatory greenhouse gas ("GHG") reporting requirements for large sources of GHG emissions in the United States. Most notably, however, in February 2010, the SEC issued an interpretive release to provide guidance on its nonfinancial disclosure requirements pertaining to climate change. While being careful to avoid opining on the existence, intensity, or sources of climate change, the SEC recommended that firms consider the potential legal, strategic, and direct impacts that climate change may have on firm operations.

In a news release about the guidance, the SEC highlighted these potential triggers for disclosure:

- *Impact of Legislation and Regulation*: When assessing potential disclosure obligations, a company should consider whether the impact of certain existing laws and regulations regarding climate change is material. In certain circumstances, a company should also evaluate the potential impact of pending legislation and regulation related to this topic;

- *Impact of International Accords*: A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change;
- *Indirect Consequences of Regulation or Business Trends*: Legal, technological, political, and scientific developments regarding climate change may create new opportunities or risks for companies. For instance, a company may face decreased demand for goods that produce significant GHG emissions or increased demand for goods that result in lower emissions than competing products. As such, a company should consider, for disclosure purposes, the actual or potential indirect consequences it may face due to climate change- related regulatory or business trends; and
- *Physical Impacts of Climate Change*: Companies should evaluate for disclosure purposes the actual and potential material impacts of environmental matters on their business.

This guidance was commended by various environmental and investor groups as a significant step forward in improving the quality and consistency of climate-risk disclosure in the U.S. The guidance was not, however, issued without opposition. Former SEC Commissioners Kathleen Casey and Troy Paredes voted against the guidance, questioning its timing and whether the SEC was an appropriate body to address environmental and social issues.[1]

Some investors, politicians, and environmental groups continue to push for more mandatory environmental and social disclosures. For example, on October 1, 2018, two law school professors—Cynthia Williams of York University and Jill Fisch of the University of Pennsylvania—together with numerous institutional investors who collectively managed more than $5 trillion in assets, submitted a petition for rulemaking to the SEC calling for the SEC to develop a standardized comprehensive framework under which public companies would be required to disclose identified ESG factors relating to their operations.

Specifically, regarding climate disclosure, mandating disclosures that rely on speculative long-term predictions about climate change could expose companies to fraud liability, according to J.W. Verret, a professor at George Mason University's Antonin Scalia Law School and a member of the SEC's Investor Advisory Committee. Former SEC Chairman Jay Clayton also confirmed a current rule that companies only need to disclose "material" risks, defined as what a "reasonable shareholder might consider important."[2,3] However, in September 2018, Senator Elizabeth Warren of Massachusetts introduced the Climate Risk Disclosure Act and one year later reintroduced the act, which would require every public company to disclose critical information about their exposure to climate change risks.[4] More recently, the Climate Risk Disclosure Act of 2021 was approved by the U.S. House Committee on Financial Services and is currently undergoing the legislative process. Further, the U.S. House Committee on Financial Services subcommittee on Investor Protection, Entrepreneurship and Capital Markets convened on July 10, 2019 and heard testimony regarding the future of ESG disclosure for public companies and its impact on investors.

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[1] Ron McFall, James M. Kearney, Reed Topham. "SEC Adopts Interpretive Guidance on Disclosure Regarding Climate Change." *Lexology*. February 12, 2010.
[2] Alana L. Griffin, Michael J. Biles, Tyler J. Highful. "Institutional Investors Petition the SEC to Require ESG Disclosures." *Business Law Today.* January 11, 2019.
[3] Gabriel T. Rubin. "Show Us Your Climate Risks, Investors Tell Companies." *The Wall Street Journal.* February 28, 2019.
[4] Emma Newburger. "Elizabeth Warren Reintroduces Legislation Requiring Corporations to Disclose Climate Risk Exposure." *CNBC*. July 10, 2019.

In August 2019, the SEC voted to propose amendments to modernize the descriptions of business, legal proceedings, and risk factors in Reg S-K. Notably, human capital is one of the proposed items for mandatory disclosure. The rule amendments were adopted in August 2020, arriving as interest in human capital disclosure has grown, in part thanks to the Human Capital Management Coalition, a group of institutional investors with more than $9 trillion in AUM. In mid-2017, the group of investors petitioned the SEC to adopt rules requiring issuers to disclose information about their human capital management policies, practices, and performance.[5]

In May 2020, the SEC's Investor Advisory Committee debated and endorsed the Investor as Owner Subcommittee's recommendations that the SEC begin an effort to update the reporting requirements of issuers to include material, decision-useful ESG factors. The Subcommittee's recommendations offer considerations for companies in preparing currently required SEC filings and voluntary sustainability reports, stating:

- Investors regard ESG information as material, but cannot get consistent information;
- The unregulated market of third party ESG data providers is burdensome, confusing, and does not satisfy investor or issuer needs;
- Issuers vary widely in their approaches to ESG disclosure;
- The SEC is aware of the problem and the need to act carefully; and
- The SEC should take timely action to address investor needs for relevant, material, decision-useful ESG disclosure:
    - Investors require reliable, material ESG information upon which to base investment and voting decisions;
    - Issuers should directly provide material information to the market relating to ESG issues used by investors to make investment and voting decisions;
    - Requiring material ESG disclosure will level the playing field between issuers;
    - ESG disclosure requirements will ensure the flow of capital to U.S. markets and to U.S. issuers of all sizes; and
    - The U.S. should take the lead on disclosure of material ESG disclosure.[6]

In June 2021, the Corporate Governance Improvement and Investor Protection Act passed the House. This bill requires publicly traded companies to periodically disclose information related to ESG performance metrics and climate change-related risks, including direct and indirect GHG emissions and fossil fuel-related assets. The bill will also establish the Sustainable Finance Advisory Committee, which must recommend to the SEC policies to facilitate the flow of capital toward environmentally sustainable investments. Further, the bill incorporates the ESG Disclosure Simplification Act of 2021 and the Climate Risk Disclosure Act of 2021, both of which would amend the Securities Exchange Act of 1934 to direct the SEC to set rules requiring standardized ESG disclosures.

In March 2022, the SEC proposed rule changes that would require registrants to include climate-related disclosures in their registration statements and periodic reports, including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial

[5] Cydney Posner. "SEC Proposal to Modernize Reg S-K." Harvard Law School Forum on Corporate Governance. August 20, 2019.
[6] W. Andrew Jack, William Mastrianna. "Will the SEC Offer Hope for Clear, Uniform Sustainability Disclosure Standards?" *Covington*. May 22, 2020.

condition, and certain climate-related financial statement metrics in a note to their audited financial statements. According to its most recent rulemaking agenda, the SEC will consider finalizing its March 2022 proposal in the spring of 2024.[7] The SEC's proposed rule followed the introduction of mandatory climate risk disclosures by regulators in several other countries, including the UK, the EU, Switzerland, Hong Kong, Japan, Singapore, and New Zealand. Additionally, Australian regulators have cited the Task Force for Climate-Related Financial Disclosures ("TCFD") recommendations as being best practice for climate-related financial disclosures, and has proposed mandatory climate-related reporting for large businesses and financial institutions starting in 2024, with smaller entities phased in over the following three years.[8]

California's Climate Disclosure Laws

California Governor Gavin Newsom signed the Climate Corporate Data Accountability Act into law in October 2023, requiring companies that are active in the state and generate revenue of more than $1 billion annually to publish a comprehensive account of their carbon emissions beginning in 2026. It is estimated that the new laws apply to about 1,400 U.S. listed companies.[9] The Act requires certain companies to disclose their direct (Scope 1), indirect (Scope 2), and value chain (Scope 3) greenhouse gas emissions, and the Climate-Related Financial Risk Act, requires certain companies to disclose climate-related financial risks pursuant to the Task Force on Climate-Related Financial Disclosures ("TCFD") recommendations.[10]

The California legislation was supported by many large companies, including Microsoft, Apple, and Ikea.[11] However, the U.S. Chamber of Commerce, along with the American Farm Bureau Federation and several California business groups filed a lawsuit in Los Angeles federal court in January 2024 seeking to overturn the new climate disclosure laws, citing "massive" costs on businesses and violating free speech protections in the U.S. Constitution by mandating the greenhouse gas emissions disclosures and climate-related financial risks.[12]

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[7] Soyoung Ho. "SEC Once Again Delays Action on Final Climate Disclosure Rule." *Thomson Reuters*. December 12, 2023.
[8] Mark Segal. "Australia to Introduce Mandatory Climate-Related Reporting for Companies Starting 2024." *ESG Today*. June 27, 2023.
[9] Isla Binnie. "Companies Fear Lawsuits from California's Climate Disclosure Rules." *Reuters*. October 12, 2023.
[10] Loyti Cheng, et al. "California Enacts Major Climate-Related Disclosure Laws." Harvard Law School Forum on Corporate Governance. October 22, 2023.
[11] Isla Binnie. "California Senate Passes Climate Bill, Governor Must Decide by Oct 14." *Reuters*. September 13, 2023.
[12] Clark Mindock. "California's Landmark Climate Disclosure Laws Challenged by Business Groups." *Reuters*. January 30, 2024.

Sustainability Reporting Regulation and Guidance outside the U.S.

Global sustainability reporting trends also indicate the possibility of stricter regulation regarding disclosure in the future. According to a 2014 report from the Sustainable Stock Exchanges Initiative, 19 of the G20 nations had regulations requiring the disclosure of some social and environmental metrics by companies, and a third of the regulators on the board of the International Organization of Securities Commissions had introduced a sustainability reporting initiative.

European Union

In 2014, the European Union adopted the Non-Financial Reporting Directive ("NFRD"), which, on a comply-or-explain basis, required large public-interest companies with over 500 employees to disclose information on policies, risks, and outcomes on sustainability-related issues, or to explain why the information is not being disclosed. Further, a 2016 collaboration of leading stakeholders including the United Nations Environmental Program, the Global Reporting Initiative, and KPMG found that sustainability reporting requirements are on the rise globally and predicted the continued expansion of these requirements by stock exchanges and governments.

In June 2022, the Council of the EU and European Parliament reached a provisional political agreement on the Corporate Sustainability Reporting Directive ("CSRD"). The CSRD amends the 2014 NFRD and is intended to address shortcomings in the disclosure of nonfinancial information, and significantly increase the number of companies that are subject to EU sustainability reporting requirements. The CSRD introduces more detailed reporting requirements and ensures that large companies are required to report on sustainability issues like environmental rights, social rights, human rights, and governance. In addition, the CSRD includes a certification requirement for sustainability reporting, and companies will be required to report sustainability information in a clearly identifiable, dedicated section of their management reports, which must be made publicly available. The European Financial Reporting Advisory Group ("EFRAG") will establish the European Sustainability Reporting Standards ("ESRS") following technical guidance from several European agencies. As a result, companies in scope of the CSRD will be required to comply with the detailed ESRS being developed by EFRAG.[13] The CSRD aims to improve the flow of sustainability information in the corporate world and will make sustainability reporting by companies more consistent, so that investors and other users of the reports can use comparable and reliable sustainability information.

EU rules pertaining to nonfinancial information currently apply to all large companies and all companies listed on regulated markets. In addition, these companies are responsible for assessing nonfinancial information for their subsidiaries. The new rules will also apply to small and medium- size enterprises ("SMEs"), but an opt-out

[13] Kolja Stehl, Leonard Ng, Matt Feehily. "EU Corporate Sustainability Reporting Directive – What Do Companies Need to Know." Harvard Law School Forum on Corporate Governance. August 23, 2022.

will be possible for SMEs during a transitional period. In other words, SMEs are exempted from the application of the CSRD directive until 2028.

The CSRD also covers non-European companies and requires that a sustainability report be produced by all companies generating a net turnover of €150 million in the EU and which have at least one subsidiary or branch in the EU. Such companies are required to produce a report on their ESG impacts, as defined by the CSRD.

Furthermore, sustainability reporting must be certified by an accredited independent auditor or certifier to ensure that the sustainability information complies with the certification standards that have been adopted by the EU. Certification also applies to the reporting of non-European companies, which are required to use a European auditor, or an auditor established in a third country.

KPMG reports that the current NFRD covers approximately 11,700 companies and the CSRD is expected to significantly increase the number of companies subject to EU sustainability reporting requirements to about 49,000.

In November 2022, the European parliament adopted the CSRD. The European Council adopted the proposal on November 28. The CSRD entered into force on January 5, 2023 and will start applying between 2024 and 2028, according to the following timeline:

- From January 1, 2024 for large public-interest companies, whether listed on stock exchanges or not, with over 500 employees already subject to the NFRD, with reports due in 2025;
- From January 1, 2025 for large companies that are not presently subject to the NFRD with more than 250 employees and/or €40 million in turnover and/or €20 million in total assets, with sustainability reports due in 2026;
- From January 1, 2026 for listed SMEs and other undertakings, with sustainability reports due in 2027. However, listed SMEs can opt-out until 2028.

More recently, the European Parliament approved a draft proposal to delay sector-specific ESG disclosure rules to 2026 for the oil, energy, and mining industries. The intention is to provide companies time to focus on implementing initial, broader ESG disclosures which they must include in their annual reports for 2024 and onwards under the CSRD.[14] More specifically, lawmakers voted to delay key aspects of the CSRD until 2026, including the adoption of standards for companies to provide sector-specific sustainability disclosures and for sustainability reporting from companies outside of the EU. The delay is also meant to provide EFRAG the time to develop quality standards and give time to companies to implement them.[15] From 2026 onward, EU businesses and their non-EU counterparts will be expected to apply sector specific European Sustainability Reporting Standards ("ESRS").[16]

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[14] Huw Jones. "EU Lawmakers Back Delay to Sector-Specific ESG Corporate Disclosures to 2026." *Reuters*. January 24, 2024.
[15] Mark Segal. "EU Lawmakers Approve 2 Year Delay of Sustainability Reporting Standards for Specific Sectors and Non-EU Companies." *ESG Today*. January 24, 2024.
[16] Stephen Bouvier. "EU Parliament Writes Two-year Delay into ESG Reporting Rules." *Investment & Pensions Europe*. January 26, 2024.

Australia

Sustainability reporting may soon become mandatory in Australia, following the Treasury's recent consultation and policy position statement. Further, the Australian Securities & Investments Commission ("ASIC") has recently expressed interest in sustainability disclosures. In addition, the Australian Accounting Standards Board ("AASB") published a position paper supporting the voluntary adoption of the TCFD recommendations, but it did not mandate such disclosure. Neither the ASIC or the AASB have provided guidance on where sustainability reports should be positioned for Australian companies, whether in the financial statements or as an independent sustainability report.[17]

However, in October 2023, the Australian government released its draft standards for reporting climate-related financial risks, as part of its preparation to introduce mandatory climate reporting for large businesses and financial institutions. The proposed standards, modified from the ISSB's to suit Australian conditions, would require firms to annually disclose their GHG emissions data, reduction targets, and other climate-related efforts, including their metrics and governance practices.[18] In January 2024, the government proposed new legislation that would make climate-related reporting, as described in the AASB's draft standards, mandatory for large companies and financial institutions. The legislation also includes a phased-in approach for Scope 3 reporting, allowing companies another year from the beginning of their disclosure requirements to start reporting value chain emissions.[19] The government has suggested that first reporting could be required for the 2024/2025 financial year.

Canada

The Canadian Sustainability Standards Board ("CSSB") was formed in June 2022 and be*came* operational *in June 2023*. *The CSSB will partner with the International Sustainability Standards Board ("ISSB") by supporting ISSB standards in Canada*, *highlighting key issues within the Canadian context*, and by facilitating synergy between ISSB standards and any CSSB standards.[20] In addition, the IFRS Foundation will establish a center in Montreal to fully integrate ISSB within the Canadian sustainability ecosystem. While a timeline for mandatory sustainability reporting has not been confirmed, "it is expected the CSSB will determine what will be required for sustainability reporting and disclosures in capital markets at some point in 2023."[21] *As of this writing, no regulatory body in Canada has indicated when* the ISSB's new sustainability standards (IFRS S1 *and* IFRS S2) *will be required.*[22]

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[17] Aletta Boshoff. "Is FY23 the Year of the Sustainability Report?" BDO Australia. June 20, 2022.
[18] Deborah Nesbitt. "Australia Releases Draft Climate Risk Disclosure Standards." *Bloomberg Law.* October 26, 2023.
[19] Mark Segal. "Australia Proposes New Law Requiring Mandatory Climate Reporting for Companies." *ESG Today*. January 15, 2024.
[20] Financial Reporting & Assurance Standards Canada. "CSSB Now Operational with New Member Appointments as First ISSB Standards Released." *Canada Newswire*. June 26, 2023.
[21] Edward Olson. "Imminent Arrival of Global Sustainability Standards Impacts the Future of Your Business." MNP LLP. August 11, 2022.
[22] Pierre Taillefer. "What Are the ISSB's New Sustainability Standards?" BDO Canada. January 9, 2024.

China

ESG-related disclosure is also a priority for Chinese regulators. In June 2022, voluntary disclosure guidelines were published by the China Enterprise Reform and Development Society. The guidelines, which place a heavy emphasis on compliance with Chinese law, are particularly tailored to China-focused ESG priorities such as common prosperity and social stability. According to an article by Thomson Reuters, "Chinese regulators have promoted the guidance as a working solution to standardized corporate ESG disclosure reporting in China that is more relevant to investors in the domestic market than standards based off practices in the United States and the European Union." A report published by the World Economic Forum and PwC China found that as of mid-2020, there were over 1,020 companies listed on the Shanghai and Shenzhen stock exchanges that voluntarily published annual ESG reports, compared to 371 companies in 2009.[23] Further, according to Bloomberg Intelligence, the number of Shanghai-listed firms issuing ESG reports grew 20% in 2021, while Shenzhen firms issuing ESG reports grew 13%, the fastest pace in a decade.[24]

ESG disclosure has continued to increase in China. According to a 2023 report by Fidelity, more than half (53%) of companies in China have publicly announced an ESG strategy or sustainability strategy, while almost 30% of companies have stated that they are addressing sustainability issues internally. The remaining 18% have plans to publicly announce their strategies in the future. However, the quality of the reporting varies widely from company to company.[25]

Sustainable Stock Exchanges Initiative

A 2018 report from the Sustainable Stock Exchanges Initiative ("SSE") found that public commitments to advancing sustainability had been made by 78 partner exchanges from five continents, on which over 45,000 companies were listed and which represented (at the time of publication) a market capitalization of more than U.S. $80 trillion. This included nine of the ten largest exchanges in the world, as well as several small exchanges from developing countries. As of this writing, the SSE has 130 member exchanges globally, which consist of 72 exchanges that provide written guidance on ESG reporting and 62 exchanges with sustainability reports.

External Assurance

The International Auditing and Assurance Standards Board ("IAASB") is an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, quality control, review, other assurance, and related services, and by facilitating the convergence of international and national standards. According to the IAASB, external assurance plays a key role in enhancing trust and confidence in financial and nonfinancial reporting. As sustainability reporting evolves, "demand for assurance engagements that enhance the degree of confidence of the intended users of sustainability/ESG reporting is growing." According to a 2022 report, more than one-third (36%) of S&P 500 companies obtain external assurance for at least some of their sustainability information, compared to only 6% of S&P MidCap 400 companies. Further, a

[23] Helen Chan. "China Moves to Standardize Fragmented ESG Reporting Landscape." *Thomson Reuters*. October 6, 2022.
[24] Sheryl Tian Tong Lee. "China Unveils ESG Reporting Guidelines to Catch Peers." *Bloomberg News*. August 16, 2022.
[25] Michelle Ng. "ESG Integration and Disclosure on the Rise in China." *ESG Clarity*. May 30, 2023.

2023 report from KPMG found that 75% of companies globally are not ready to have their ESG data audited externally, and that only 25% of companies feel that they are sufficiently prepared. Additionally, KPMG reports that larger companies are better prepared for auditing than smaller firms, and among countries, France, Japan, and the United States are better prepared whereas Brazil and China ranked the least prepared.[26]
Currently, the IAASB is working on a project to develop an overarching standard for assurance on sustainability reporting that is:

- Responsive to the public-interest need for a timely standard that supports the consistent performance of quality sustainability assurance engagements;
- Suitable across all sustainability topics, information disclosed about those topics, and reporting frameworks; and
- Implementable by all assurance practitioners.

The new standard for assurance on sustainability reporting will address:

- Both limited assurance and reasonable assurance;
- The conduct of an assurance engagement in its entirety; and
- Areas of sustainability assurance engagements where priority challenges have been identified, and more specificity is required.

The IAASB anticipates that a suite of standards for assurance on sustainability reporting that provide more specificity than an overarching standard will probably need to be developed over time. Therefore, the IAASB plans to explore additional development of the suite of assurance standards on sustainability reporting as part of its future standard-setting activities. Furthermore, the IAASB's efforts to develop sustainability assurance standards will complement the efforts by the International Sustainability Standards Board ("ISSB"). It is important to note that the foundation that established the ISSB, the IFRS Foundation, is a counterpart organization to the IAASB, which serves over 130 countries.

[26] Tommy Reggiori Wilkes. "Three-Quarters of Firms Globally are Not Ready for New ESG Rules, KPMG Finds." *Reuters*. September 26, 2023.

Reporting Standards

In response to piecemeal and often unclear or insubstantial disclosure of sustainability-related issues, there has been a widespread push by a variety of global actors to standardize and heighten the quality of such reporting. A few organizations in particular have made strides in shaping the sustainability-reporting landscape:

The International Integrated Reporting Council

Especially in Europe, integrated reporting has gained popularity in recent years, with companies reporting their social and environmental impacts as a part of their annual report. An integrated report measures financial and nonfinancial performance, as well as the relationships between them. Formed in 2010, the International Integrated Reporting Council ("IIRC") launched a two-year pilot program which ultimately resulted in the development of an internationally-accepted integrated reporting framework that encompasses financial, environmental, social, and governance issues.

In December 2013, the IIRC published its International Integrated Reporting Framework, which is designed to work with existing reporting standards, including the Global Reporting Initiative ("GRI") guidelines. In fact, on February 1, 2013, the GRI and the IIRC issued a memorandum of understanding stating their intention to deepen their cooperation in the evolution of corporate reporting. In the memorandum, the IIRC indicated that it intends to encourage companies to use existing standards and guidelines, such as the GRI guidelines, in conjunction with its reporting framework. Further, in September 2020, IIRC joined with the GRI, CDP, Climate Disclosure Standards Board, and the Sustainability Accounting Standards Board ("SASB") to work toward setting a comprehensive global reporting standard. However, in June 2021, the IIRC merged with SASB to form the Value Reporting Foundation ("VRF"). Subsequently, in August 2022, the VRF was consolidated into the IFRS Foundation, which created the new ISSB to develop a comprehensive global baseline of sustainability disclosures for the capital markets. Today, the IFRS Foundation's International Accounting Standards Board ("IASB") and the ISSB are jointly responsible for the Integrated Reporting Framework.

Since the creation of the IIRC, integrated reporting has gradually increased in popularity. The World Business Council for Sustainable Development ("WBCSD") has tracked the reporting practices of its members and found that, in 2022, 35% of reports reviewed combine financial and nonfinancial information, slightly down from 39% in 2019. Further, according to KMPG's 2022 survey, there has been a significant increase in the number of companies applying the International Integrated Reporting Framework since 2020. Specifically, notable growth occurred in the following regions between 2020 and 2022: 34% in India, 20% in Poland, 18% in Panama, and 17% in Japan.

Although the clear majority of companies have yet to produce truly integrated reports, it appears the trend is toward adoption of this reporting structure. Not only are organizations like GRI and ISSB working toward more integrated reporting, but major accounting firms have also promoted the use of this disclosure method. Ernst & Young and KPMG, for example, have published extensive analyses of the value-creating benefits of integrated reporting and use the IIRC framework as the starting point.

According to KPMG's survey of sustainability reporting, integrated reporting has taken hold among the N100 companies and is now strong in the Middle East and Asia Pacific, with 55% and 30% of the top 100 companies in

those regions, respectively, issuing such reports. In addition, notable growth has occurred in Latin America since 2020, increasing by 12%, to 28% of companies. KPMG states that the increase in integrated reporting "may be driven by a combination of regulation and investor influence to encourage greater transparency of non-financial data."[27]

The Global Reporting Initiative

The recognition that a substantial portion of market capitalization was made up of intangible elements such as governance, human capital management, and legitimacy of operations and supply chain led to the development of sustainability reporting by the GRI. It is the most popular sustainability-reporting framework, with 82% of the world's largest 250 corporations reporting against it,[28] and shareholder proposals often request that a sustainability report be prepared according to its standards. The GRI framework enables companies to measure and report their economic, environmental, social, and governance performance. Companies must establish an ongoing reporting cycle to monitor their sustainability performance and periodically provide senior management with information to help it shape company strategy and policy and improve performance. Since its formation, the GRI has released several iterations of its reporting guidelines. The most recent version, the GRI Standards, are based on its former G4 Guidelines and can be used in their entirety to prepare a sustainability report, or companies can use selected Standards or parts of their content to report information for specific users or purposes.

Reporting in accordance with the GRI standards has gained popularity among major corporations. As of 2022, KPMG reports that more than two-thirds of N100 reporters and over three-quarters of G250 reporters used GRI Standards to prepare their reports. KPMG's 2022 survey reaffirms that the GRI remains the most dominant sustainability reporting standard, with Singapore, Taiwan, and Chile leading the increase of GRI usage since 2020.

The GRI provides its position on the sustainability reporting landscape and states that it is working with the IFRS Foundation and the European Financial Reporting Advisory Group ("EFRAG") to achieve greater alignment and harmonization for the benefit of companies, investors, and society at large.

The Task Force on Climate-related Financial Disclosures

The Task Force on Climate-related Financial Disclosures ("TCFD") was responsible for developing voluntary climate-related financial risk disclosures based on considerations of the physical, liability, and transition risks associated with climate change and what constitutes effective financial disclosures across industries. The TCFD's recommendations were intended to help companies understand what kinds of disclosure financial markets want

[27] "Big Shifts, Small Steps: Survey of Sustainability Reporting 2022." KPMG International. October 2022.
[28] "Comparison of ESG Reporting Frameworks." *Bloomberg Law*. August 11, 2022.

in order to measure and respond to climate change risk. On June 29, 2017, the TCFD released three documents to aid in implementation of its recommendations, including a final report on its recommendations, an annex on their implementation, and a technical supplement including use of scenario analysis.

Following the release of its 2023 status report, the TCFD fulfilled its remit and was disbanded. The TCFD is now being subsumed into the ISSB, with the ISSB taking over the monitoring of the progress on companies' climate-related disclosures from 2024 onward.

As of its final status report in October 2023, the TCFD had more than 4,800 supporters, across a broad range of sectors, with a combined market capitalization of $29.5 trillion, including more than 1,800 financial institutions responsible for assets of $222.2 trillion (p.81).

The Sustainability Accounting Standards Board

The Sustainability Accounting Standards Board ("SASB") published its standards in late 2018 with a mission to develop and disseminate sustainability accounting standards that aid in the disclosure of material information to investors. SASB's approach is to use evidence-based research and balanced stakeholder participation to ensure that it is market-informed. SASB has established 77 industry-specific standards to assist companies in disclosure. In August 2022, SASB was consolidated into the IFRS foundation, which intends to become the global standard-setter for sustainability disclosures for financial markets. The IFRS Foundation Trustees created the ISSB to respond to an urgent demand for transparent financial-related sustainability disclosures by companies. The ISSB states that it is committed to maintaining, enhancing, and evolving the SASB Standards and encourages investors and others to continue to use them.

Prior to the consolidation into the IFRS foundation, the SASB Conceptual Framework was in the process of being revised and underwent a public consultation. The conceptual framework exposure draft, which was available for public comment between August 28, 2020, and December 31, 2020, has been published. The original version of the SASB Standards framework was designed for voluntary use in disclosures required by existing U.S. regulations such as on Forms 10-K and 20-F with the SEC. According to SASB, sustainability accounting is meant as a "complement to financial accounting," helping to provide a "more complete view of a corporation's performance on material factors likely to affect its ability to create long-term value." To ensure that disclosure is tailored to the company providing the disclosure, and therefore material to its operations, SASB developed specific sustainability-related indicators for each sector. These indicators were developed in collaboration with stakeholders and then subjected to a 90-day public comment period. In January 2020, the world's largest asset manager, BlackRock, specifically asked companies to use SASB metrics.[29] Since 2020, there are 3,069 unique SASB reporters across 79 jurisdictions.

Because sustainability disclosure varies significantly across sectors, distinguishing between material and immaterial factors is crucial for investors to determine which sustainability investments are in their best interest. In a 2015 Harvard Business School study, SASB's standards development process was tested to

[29] Emily Chasan. "Corporate Sustainability Reporting Is Growing Up." *Bloomberg*. August 19, 2020.

determine how it reflects corporate performance on material and immaterial sustainability issues. The research indicated that firms with strong ratings on material issues and poor ratings on immaterial issues have the best future performance. Essentially, the findings demonstrate that SASB's materiality guidance is indeed helpful in improving the usefulness of ESG data for investors.

In terms of ensuring corporate compliance, SASB's proposed actions may fall short, particularly when there is no regulatory mandate driving the initiative. Given that SASB originally aimed to have companies report on sustainability-related issues in their Form 10-K filings, companies will face additional obstacles that they might argue are unwarranted. For example, given that regulatory documents are subject to significantly more scrutiny than a stand-alone sustainability report, legal counsel and senior executives may be unwilling to present information not required by law, particularly when such information could potentially elicit negative reactions from stakeholders. Indeed, according to a 2021 study, "the inclusion of ESG-related information from sustainability reports and other thematic ESG reports in regulatory filings creates legal risks and should be pursued only after close coordination within the company among appropriate departments (e.g., the legal department and sustainability team) and in consultation with counsel specialized in securities law and ESG disclosures."[30] However, in recent years, SASB moved away from the approach of pushing for this disclosure in regulatory filings, and had, instead, encouraged for the disclosure of the metrics in whatever form companies deem most appropriate.

Adoption of SASB's indicator disclosure requirements could present windfall benefits for investors and the reporting company as the additional disclosure has the potential to provide investors with clear, comparable information. However, it appears that there is still room for improvement in achieving this transparency. SASB's first State of Disclosure Report found that, while over 80% of disclosures analyzed across SASB disclosure topics included some level of sustainability disclosure, more than half of companies used boilerplate language and fewer than 25% contain metrics.[31]

KPMG reports that the SASB standard is the leading reporting standard among companies in the United States, Canada, and Brazil. Over half of the companies in the Americas report against SASB standards.

The International Sustainability Standards Board

The International Sustainability Standards Board ("ISSB") was formed after the consolidation of the Climate Disclosures Standards Board ("CDSB") and VRF (which included the IIRC and SSB) into the IFRS Foundation. As announced on November 3, 2021, at COP 26, the ISSB:

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[30] Kai H.E. Liekefett, Holly J. Gregory, Leonard Wood. "Shareholder Activism and ESG: What Comes Next, and How to Prepare." Harvard Law School Forum on Corporate Governance. May 29, 2021.
[31] Jeanne Solomon, Stacy Stecher. "SASB Issues Inaugural Report Benchmarking and Ranking Sustainability Disclosures." *Mondaq*. February 1, 2017.

> *"[w]ill develop, in the public interest, IFRS Sustainability Disclosure Standards that provide a global baseline of disclosure requirements designed to give investors high quality, globally comparable sustainability information that can be used by jurisdictions on a standalone basis or incorporated into requirements to meet broader, multi-stakeholder or public policy needs."*

In November 2022, the ISSB confirmed that companies will be required to use climate-related scenario analysis to inform resilience analysis. Further, the ISSB stated its intention to refer to and build on TCFD guidance for scenario analysis.

The ISSB issued its inaugural global sustainability disclosure standards in June 2023, beginning a new era of sustainability-related disclosures in capital markets across the world. IFRS S1 provides a set of disclosure requirements designed to enable companies to communicate to investors about the sustainability-related risks and opportunities they face over the short-, medium-, and long-term. IFRS S2 outlines specific climate-related disclosures and is intended to be used along with IFRS S1. Both standards fully incorporate the recommendations of the TCFD, and are designed to ensure that companies provide sustainability-related information alongside financial statements in the same reporting package.

In November 2022, CDP announced that it will incorporate ISSB climate-related disclosure standards into its global environmental disclosure platform.

The Task Force on Nature-related Financial Disclosures

The Task Force on Nature-related Financial Disclosures ("TNFD") is responsible for developing and delivering a risk management and disclosure framework for organizations to report and act on evolving nature-related risks. Its disclosure recommendations are structured around four pillars (governance, strategy, risk & impact management, metrics & targets) consistent with TCFD and the ISSB. The TNFD aims to provide decision makers in business and capital markets with better quality information through corporate reporting on nature that improves enterprise and portfolio risk management. The TNFD Taskforce represents financial institutions, corporates, and market service providers with over U.S.$20 trillion in assets under management across 180 countries.

Global ISSB Standards versus the EU's CSRD

The disparate frameworks for companies to report on sustainability issues are soon to be replaced by widely accepted and endorsed international standards. With that in mind, companies, investors, and stakeholders are likely to question how initiatives like the ISSB standards, which are meant to be global standards, overlap with the CSRD standards in the EU. It is important to note that the ISSB and the EFRAG are communicating and coordinating their efforts, and the ISSB plans to include the EU in its multi-stakeholder consultative committee, which includes representatives from different jurisdictions around the world. However, the differences between the ISSB and CSRD merit discussion.

The global standards are meant for all jurisdictions worldwide; are intended to be applicable in different cultural, business, legal, and regulatory environments; and may remain voluntary for an extended period. The ISSB has explicitly committed to starting with only climate disclosures, whereas the EFRAG plans to use a more comprehensive approach, by emphasizing the interdependence between various ESG impacts from companies, while also issuing a robust climate standard.

Further, the ISSB's global standards are based on a financial materiality approach, in which sustainability impacts are measured in terms of the impacts on a company's financial position and its prospects. In contrast, European standards are being developed based on a double materiality principle, where sustainability disclosure is mandated from the financial impact on the company (outside in) and the impact of the company on society and the environment (inside out).

Other notable differences are that investors are intended to be the primary users of reports produced under ISSB standards, whereas the European standards require reports aimed at investors and a wide range of stakeholder groups. Nevertheless, both the ISSB and the CSRD standards are a response to "the same extensive and persistent demands from business, capital markets and stakeholders for unified standards to enable company sustainability performance to be reported, comparable and rewarded." [32] Even though differences may exist in the beginning, it is likely that investor demand will be exerted on both the ISSB and the EU to find consistency to ensure standardized sustainability reporting backed by regulation.

[32] Richard Howitt. "How European and Global Sustainability Standards for Corporate Reporting Can and Will Converge." *Reuters Events*. April 13, 2022.

Benefits of Sustainability Initiatives and Reporting

Ample research suggests a wide variety of benefits may be realized from pursuing and reporting on sustainability initiatives. These benefits are not only economic but also reputational and social. According to a 2015 Ernst & Young survey, the main drivers behind such reporting are:

- Improved financial performance;
- Access to capital;
- Risk management;
- Innovation, waste reduction, and efficiency;
- Reputation and consumer trust;
- Employee loyalty and recruitment; and
- Social benefits.

Further, in a 2017 meta-analysis of the literature regarding the relationship between Corporate Social Responsibility ("CSR")/ESG and financial performance, authors Brooks and Oikonomou found that ESG disclosures are generally associated with both improved ESG performance and firm performance. Their key findings, among others, include:

- There is a positive and statistically significant though economically modest link between corporate social performance ("CSP") and financial performance at the firm level.
- The risk-adjusted performance of socially responsible investment ("SRI") funds and indexes is statistically indistinguishable from that of conventional funds and indexes.
- There is asymmetry in the financial impacts of CSP whereby the negative financial effects of corporate social irresponsibility are stronger than the positive financial effects of corporate social responsibility.
- ESG/CSP appear to be related to and influence important corporate decisions such as executive remuneration and mergers and acquisitions.

A 2016 report from the London School of Economics found that companies dedicated to CSR goals had stock returns that were four to seven percentage points higher than their less CSR-oriented peers. Likewise, in 2012, resource-efficient companies (defined as those that use less energy and water and create less waste in generating a unit of revenue) were found to produce higher investment returns than their less resource-efficient peers, with these resource-efficient companies also displaying higher levels of innovation and entrepreneurship.[33] A 2018 study found that companies that contribute to the Sustainable Development Goals experience a "do good, do well" effect when they have strong performance on material ESG issues. This

[33] Gerrit Heyns. "Companies that Invest in Sustainability Do Better Financially." *Harvard Business Review*. September 19, 2012.

supports a 2017 finding that firms that voluntarily disclose more SASB-identified sustainability information have higher stock price informativeness. Further, a 2021 study from the Harvard Business School reaffirms that companies that voluntarily disclose more SASB-identified sustainability information have higher stock price informativeness whereas sustainability disclosures not identified as material by SASB are not associated with informativeness.

CSR performance may also be correlated with fewer capital restraints and greater access to capital. A study by researchers at Harvard Business School and the London Business School found that better CSR performance is the result of improved stakeholder engagement, which reduces the likelihood of opportunistic behavior and compels managers to adopt a more long-term strategy. This, in turn, introduces a more efficient form of contracting with key constituents. Moreover, firms with relaxed capital constraints can undertake other profitable investments that may lead to improved financial performance. The study concluded that companies employing positive CSR practices are likely to disclose these practices, thereby increasing their overall transparency, easing investors' fears, and making these companies more likely candidates for investment.

Beyond financial benefits, sustainability initiatives may give businesses a reputational edge which could lead to a larger or more committed consumer base. For example, a 2013 Boston College Center for Corporate Citizenship and EY study showed that more than 50% of respondents issuing sustainability reports stated that those reports helped enhance firm reputation. However, there is a limit to this. As sustainability practices become common practice, they also become less strategic. In order to create strategic advantage, a company would need to adopt sustainability measures that competitors can't easily match.[34]

Sustainable business operations and the reporting on those operations can also improve companies' stakeholder relationships, particularly those with their employees. A 2017 survey by McKinsey & Company found that 21% of companies that produced a sustainability report cited attracting, motivating, and retaining employees as reasons to address sustainability topics. In line with the most common reasons organizations are pursuing sustainability, two of three activity areas relate to employees and customers: engaging employees in sustainability-related activities and marketing sustainability-related attributes to customers. However, employees are not the only stakeholder group that views sustainability reports.

Production of a sustainability or integrated report may have significant benefits in and of itself. For example, a 2017 Harvard study found that mandatory sustainability reporting has a positive impact on shareholder value. The study found that not only is ESG disclosure positively associated with an increase in shareholder value, but that increased disclosure requirements were positively associated with comparatively larger growth in shareholder value. The researchers note that companies often supplemented increased disclosure with efforts to increase credibility and comparability of the information, and that there is strong evidence that enhanced disclosure resulting from new regulations is value-enhancing for shareholders.

A sustainability report also provides companies an opportunity to frame their sustainability information in the way that best suits their individual needs, giving them an advantage over peers reporting similar data points. As

[34] Ioannis Ioannou, George Serafeim. "Yes, Sustainability Can Be a Strategy." *Harvard Business Review.* February 11, 2019.

part of Thomson Reuters research into sustainability reporting, individuals responsible for corporate sustainability disclosure "noted an appreciation for the ability to explain the most relevant data to stakeholders through strategic storytelling…" As sustainability data is broad-ranging and often highly industry specific, the sustainability reporting process allows companies to structure their disclosure to best interface with the needs and knowledge of shareholders.

Obstacles to Sustainability Reporting

As discussed above, shareholders generally benefit when companies clearly communicate their sustainability efforts through the production and dissemination of a comprehensive sustainability report. Nevertheless, sustainability reporting is a complex process given the many challenges in assessing nonfinancial indicators of performance. Unlike financial reporting, much of the data and metrics used in sustainability reporting is not yet regulated and can often be subjective.

ESG criteria can vary across companies, industries, and countries. In fact, many companies report data-related issues, such as availability, accuracy, and completeness of data, as the main challenges in the reporting process. According to a report from S&P Global, one of the main challenges is the collection, management, and quality assurance of relevant sustainability data.

With various reporting standards, companies often struggle with determining which method is best suited for their sustainability disclosure. According to survey *data* from McKinsey & Company, 75% of investor respondents and 58% of executive respondents believe there should be one sustainability reporting standard. Further, 82% of investor respondents and 66% of executive respondents believe companies should be required by law to issue sustainability reports.

Given the inherent challenges in identifying and collecting the necessary sustainability-related data, it is unsurprising that many companies have decided against disclosing extensive sustainability-related information. For example, companies may face internal conflicts about production of a sustainability report as corporate lawyers may be concerned about disclosure of sensitive information. Additionally, companies may become overwhelmed by a barrage of disparate shareholder requests for disclosure on very specific sustainability-related issues.

As noted in an Ernst & Young and Boston College Center for Corporate Citizenship study finding the resources, interest, and internal management support necessary for production of a sustainability report appears to be more feasible at larger companies, and there is often a significant gap between the sustainability-related information reported by large and small companies. Large firms are also more likely to report than smaller ones, and they appear to be more influenced by transparency expectations and competitive differentiation compared to small companies. Nevertheless, even for large firms, sustainability reporting may prove difficult; where a firm must work together with subsidiaries and suppliers in its reporting, some suppliers may not be large enough to allow for comprehensive reporting or simply may not practice sustainability reporting. However, the ISSB considered "the needs of emerging and developing economies, as well as smaller- and medium-sized companies and others within global supply chains, recognising the additional challenges faced by such companies in applying sustainability disclosure requirements," prior to publishing its IFRS Sustainability Disclosure in June 2023.

A significant obstacle to disclosure may also stem from discrepancies between ESG data that is disclosed versus internal ESG data used for managerial and investment decisions. For example, a paper from Deloitte argued that disclosure of ESG data can be as crucial and informative as disclosure of financial data, and that companies

should focus on a small set of material performance indicators while leveraging input from all key stakeholders in order to move forward on valuing and reporting ESG data in a pragmatic and cost-effective manner. In fact, a 2016 *Accounting Review* report linked company performance against materiality and the rating of sustainability issues. The report found that companies with good ratings on material sustainability issues outperformed companies with lower ratings. However, companies that have high ratings on immaterial issues showed no observable improvement in performance over peers with poor ratings on the same topics.

A 2015 report also found that inconsistent corporate disclosure on sustainability issues, including inadequate assessments of the materiality of ESG issues, presents a challenge for determining the implications of an investment, which in turn may prevent investors from fully integrating sustainability issues into their decision making process**.** In a 2020 survey of almost 300 institutional investors, dissatisfaction with ESG risk disclosures had permeated since 2018, up 14 percentage points. Further, 86% of those who were dissatisfied with the environmental risk information they receive say it is critical that disclosures in the area improve.

On a more granular level, a Thomson Reuters report found that sustainability reporting is often hampered by undeveloped pathways for data flow. For example, companies with massive supply chains could have significant trouble in tracking upstream carbon emissions or social metrics; this challenge is compounded in less-developed regions. However, the search for this information and its resulting analysis has the potential to be fruitful in unexpected ways as in-depth value chain analysis can highlight inefficiencies that can be corrected through sourcing and production changes.

Another challenge with traditional sustainability reports is that the information in the report may be outdated by the time the report is published. However, to overcome this, the Conference Board recommends that companies consider providing interactive or searchable databases that are regularly updated with sustainability information. In addition, companies can use other methods to communicate sustainability information such as annual SEC filings, corporate websites, press releases, case studies, social media, investor presentations, news articles, conferences, and customer meetings.[35]

Finally, according to the Global Sustainable Investment Alliance ("GSIA"), a challenge is that companies will need to integrate required regulatory reporting into coherent and transparent disclosure that is decision-useful (p.18).

[35] Thomas Singer. "B2B Sustainability Disclosure: Telling Your Sustainability Story to Your Business Partners." The Conference Board. May 5, 2022.

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