GLASS LEWIS

Sustainability Reporting

In-Depth Report

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Introduction

Issues related to sustainability represent the next frontier in corporate reporting. Broadly defined, sustainability reporting includes a company's impacts, risks, and opportunities from an environmental, social, and governance (ESG) perspective. In recent years, an increased focus on sustainability-related issues has caused even the most mainstream investors to question whether companies are effectively addressing the potential 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 addition, $1 in every $4 in funds under professional management are invested using one or more ESG investment strategies.

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. Disclosure is important even to smaller companies, as captured in a report on sustainability practices from The Conference Board Initiative on Sustainability. In the 2016 report, approximately 21% of companies with revenues of less than $1 billion provided disclosure on sustainability-related information. More recent data shows that, by 2019, 90% of S&P 500 companies were publishing sustainability reports.

According to KPMG's survey of sustainability reporting, in 2020, 80% of companies worldwide were reporting on sustainability, with 90% of companies in North America reporting. Every one of the top 100 companies in Japan and Mexico report, and there has been a surge in integrated reporting in France, Japan, India, and Malaysia since 2017.

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 increased over what to report and the best way to report it.

Sustainability Reporting Regulation and Guidance in the United States

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 related to 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 reporting requirements for large sources of greenhouse gas 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 greenhouse gas 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 United States. 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 with regard to 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. SEC Chairman Jay Clayton has also confirmed a current rule that companies only need to disclose "material" risks, defined as what a "reasonable shareholder might consider important."[2,3]

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[1] Ron McFall, James M. Kearney, and 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.

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] 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.

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 $6 trillion in AUM. In mid-2017, the group of investors petitioned the SEC to adopt rules requiring issuers to disclose information about the 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 United States should take the lead on disclosure of material ESG disclosure.[6]

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[4] Emma Newburger. "Elizabeth Warren Reintroduces Legislation Requiring Corporations to Disclose Climate Risk Exposure." *CNBC*. July 10, 2019.
[5] Cydney Posner. "SEC Proposal to Modernize Reg S-K." Cooley LLP. August 20, 2019.
[6] W. Andrew Jack, William Mastrianna. "Will the SEC Offer Hope for Clear, Uniform Sustainability Disclosure Standards?" *Covington*. May 22, 2020.

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. In 2014, the European Union adopted a Directive on the disclosure of non-financial information, 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. According to their report, in 2013, there were almost 400 sustainability reporting instruments across 64 countries identified in 2016, up from 180 instruments across 44 countries.

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 increased 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) soon thereafter 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 Global Reporting Initiative (GRI), CDP, Climate Disclosure Standards Board, and the Sustainability Accounting Standards Board (SASB) to work toward setting a comprehensive global reporting standard.

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 2018, 33% of reports reviewed combine financial and non-financial information, up from 22% in 2014. Further, according to KMPG's 2020 survey, 16% of the top 5,200 global companies labelled their annual reports as integrated, up two percentage points from 2017, and 70% also reference the IIRC Framework for integrated reporting. Significant increases in integrated reporting have been seen in France, Japan, India, and Malaysia. Integrated reporting is currently a majority practice in South Africa, Japan, and Sri Lanka.

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 IIRC 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. Furthermore, the IIRC announced the launching of a six-week global consultation process in March 2019 to ascertain how to drive better alignment of sustainability reporting and support integration between non-financial and financial reporting.

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, which is the most popular sustainability-reporting framework. Shareholder proposals often request that a sustainability report be prepared in accordance with GRI 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. KPMG's 2020 survey of sustainability reporting found that the application of GRI Standards has significantly increased compared with 2017. Around two-thirds of N100 reporters and around three-quarters of G250 reporters used GRI Standards to prepare their reports.

The Task Force on Climate-related Financial Disclosures

The Task Force on Climate-related Financial Disclosures (TCFD) is 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 are intended to help companies understand what kinds of disclosure financial markets want 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.

The TCFD has quickly amassed significant support. In its 2020 status report, TCFD stated that in the preceding 15 months, the number of organizations expressing support had grown more than 85%, reaching over 1,500 organizations globally, including over 1,340 companies with a market capitalization of $12.6 trillion and financial institutions responsible for assets of $150 trillion. Currently, nearly 60% of the world's 100 largest public companies support TCFD, report in line with TCFD recommendations, or both. Energy companies and materials and buildings companies lead on disclosure, and larger companies are more likely to disclose information aligned with the recommendations. As of December 2020, TCFD had more than 1,600 supporters in 70 countries.

KPMG reports that one in five companies reports climate risk in line with TCFD recommendations and that this is expected to rise following confirmation in November 2020 that TCFD reporting will be mandatory in the UK for premium listed companies and certain financial institutions for 2021 and expanded to other companies thereafter. The UK regulator has stated that it expects public interest entities to report under both TCFD and sector-specific disclosures aligned with SASB.

The Sustainability Accounting Standards Board

The Sustainability Accounting Standards Board (SASB) was established as a nonprofit organization in July 2011 and 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, with current standards approved on October 2018 and released November 2018. It is currently updating its conceptual framework, a draft of which was available for public comment through December 31, 2020.

The SASB standards are 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. SASB's most recent State of Disclosure Report, released in December 2017, provides stakeholders with reviews of corporate sustainability disclosures in SEC filings across 11 sectors and 79 industries in the Sustainable Industry Classification System (SICS), giving industry-specific context to the effectiveness of pricing different risks and opportunities. As of August 2020, 279 companies were reporting in line with SASB standards, up from 118 in 2019, and 150 investors were using SASB metrics in their investment processes. Further, in January 2020, the world's largest asset manager, Blackrock, specifically asked companies to use SASB metrics.[7]

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 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.

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

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. However, in recent years, SASB has moved away from the approach of pushing for this disclosure in regulatory filings, and has, 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.[8] In its second State of Disclosure Report, published in 2017, SASB found that roughly 50% of companies were using boilerplate language to address a SASB topic, which marks only a slight improvement over the previous statistic. In the report, SASB found that, at the highest level of aggregation across the entire economy, including all sectors, industries, and topics, both disclosure levels and quality were "very similar" to those analyzed in the previous report.

The Climate Disclosures Standards Board

The Climate Disclosures Standards Board (CDSB) aims to provide decision-useful environmental information to markets, enabling material climate change and natural capital information to be integrated into mainstream reporting. The CDSB's framework is designed to help organizations include environmental information in their reports to investors. It was updated April 2018 to align with TCFD recommendations in an effort to streamline the reporting process. Environmental information included in the CDSB's framework includes natural capital dependencies; environmental results; climate-related risks and opportunities; environmental policies, policy outcomes, and associated strategies; and performance against environmental targets.

As of December 2017, the CDSB reported that its framework was being used by 374 companies across 10 sectors with a market capitalization of $5.2 trillion and located in 32 countries. This is up from its reported use at 314 companies with a market capitalization of $4.2 trillion in November 2015. The CDSB discloses how its framework might be used in conjunction with various other standards setters, including the GRI, the IIRC, and the SASB.

[8] Jeanne Solomon, Stacy Stecher. "SASB Issues Inaugural Report Benchmarking and Ranking Sustainability Disclosures." *Mondaq*. February 1, 2017.

The Better Alignment Project

The Better Alignment Project is a Corporate Reporting Dialogue initiative that brings together reporting standards setters to determine how they might work together to better support organizations in their ESG disclosure. Participants include the Carbon Disclosure Project (CDP), CDSB, GRI, IIRC, and SASB. The project's first year focused on climate change reporting and mapping participant frameworks and standards to the TCFD disclosure principles. This mapping revealed that:

- The TCFD's seven principles for effective disclosure are complementary with the participants' standards, revealing no sources of conflict,
- The participants were all aligned with the TCFD's 11 recommended disclosures,
- There were high levels of alignment between CDP, GRI, and SASB for the TCFD's illustrative example metrics, and
- 80% of the TCFD's 50 metrics are fully or reasonably covered by participants' indicators.

Participants also consulted stakeholders, who made it clear that they struggle to understand how the various frameworks and standards interact to contribute to efficient and effective disclosure, in response to which the participants produced a set of frequently asked questions included in the report. The answers to these frequently asked questions cover topics such as:

- Knowing where to start on sustainability reporting,
- The differences between "standards" and "principles-based" frameworks, and
- Determining which frameworks best serve a company's individual disclosure needs.

Stakeholders also expressed that the market would benefit from greater alignment of terminologies, methodologies, and stronger connections between ESG and financial information. With many stakeholders requesting action by the Corporate Reporting Dialogue to establish a single framework, the disconnect illustrated by the project indicates a need for standards setters to more clearly communicate how their respective frameworks are interconnected.

According to the Better Alignment Project, various frameworks and standards can be used in combination with TCFD reporting requirements:

- The IIRC framework addresses multiple capitals and can be used as a guide to reporting on multiple values created,
- The CDSB framework can be used as a guide to reporting material climate and environmental information in a company's annual report,
- The SASB standards provide industry-specific guidance for reporting on financially material sustainability topics. CDSB and SASB were both created solely for communication of material issues to investors and can be used in conjunction with each other,
- The CDP framework determines relevant information for climate change, water security, and forests, and
- The GRI Standards provide detailed guidance for 33 sustainability topics and their economic, social, and environmental impacts and can be used as part of an annual report to demonstrate performance on key sustainability topics or for developing a separate sustainability report serving the needs of multiple stakeholders.

Benefits of Sustainability Initiatives and Reporting

Ample research suggests a wide variety of benefits may be reaped 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 increased 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 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, and
- 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. Further, according to a 2013 study by CDP and Sustainable Insight Capital Management, companies that took industry leadership positions with respect to climate change had better performance in terms of profitability, cash flow stability, and dividend growth than their 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.[9] 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 supports a 2017 finding that firms that voluntarily disclose more SASB-identified sustainability information have higher stock price 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 competitors can't easily match.[10]

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.

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

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

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 increases 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 to peers reporting similar data points. As 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 unregulated 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 Thomson Reuters report, gathering data is the greatest day-to-day burden for sustainability reporting professionals; much of this is done manually, primarily through email outreach and spreadsheet data entry.

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. However, according to a 2018 report published by the Sustainable Investments Institute, 97% of reporting companies chose to customize extant sustainability reporting models rather than closely following any one framework. Only 10 reporting companies issued sustainability reports that followed only one reporting framework closely. 27% referenced and loosely followed just one framework, 46% referenced two or more reporting models, and 25% didn't reference any reporting models.

One response to the complexity of sustainability reporting standards is The Reporting Exchange, a WBCSD initiative that connects users to comparable information on reporting requirements across many sectors and over 70 countries. Intended for use by businesses, analysts and investors, academics, and regulators and standards setters, The Reporting Exchange allows users to search for reporting requirements and resources for specific countries, sectors, or subjects, and to track trends in ESG reporting, among other things.

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.

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 recent *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 increased across the board 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.

The obstacles that can be attributed to effective sustainability reporting are succinctly outlined in statistics from a 2018 survey of global corporate executives' opinions on various sustainability reporting matters. The survey found that 87% of respondents stated that they either use non-financial information in decision-making or are actively trying to do so. However, only 12% reported that they are confident they are capturing the right information about environmental and social outcomes. This is almost certainly a significant contributor as to why only 11% reported that they have successfully integrated non-financial information in decision-making processes.

Conclusion

Sustainability reporting has largely become a mainstay for most companies, both in the United States and internationally. Accordingly, Glass Lewis believes that companies should ensure that they are recognizing and communicating the risks and opportunities associated with sustainability-related issues in a way that mitigates risk to shareholders.

We recognize that there is still no definitive empirical evidence regarding the impact of voluntary sustainability reporting. Nevertheless, we believe that the production of a sustainability report can be an important signal of a company's commitment and willingness to ensure that its operations are managed responsibly from a social, environmental, governance, and financial perspective. We expect that, as the trend toward more and better sustainability reporting accelerates, companies will face increasing pressure from investors and institutions to ensure that they are providing comprehensive and transparent disclosure that is consistent with investors' expectations. We believe that investors should monitor companies to ensure that they are adequately addressing sustainability-related risks as these risks can often have legitimate financial implications for companies.

One 2017 study suggests that a "comply-or-explain" approach to disclosure, a tactic commonly used in European countries, could be a more effective alternative to new line-item mandates. The study found that comply-or-explain principles have proven effective in improving corporate governance practices and enhancing corporate transparency, particularly in the markets that most resemble the United States. The study's findings also suggest that comply-or-explain based corporate governance codes also yield information that is more useful to investors compared to that provided by voluntary disclosures.

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