

Headline: It's Time to Level Up Sustainability Reporting

Deck: Mandatory disclosures will give investors and other stakeholders a clearer picture of the future of your business. What story will yours tell?

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Rigorous sustainability-related financial disclosure is coming. The era of inconsistent, voluntary disclosure is giving way to mandatory reporting — but don't treat this regulatory revolution as simply an exercise in compliance. It is instead essential work to gain greater visibility into your business's exposure to risk and long-term prospects for success — for the benefit of both investors and management.

Action has been brisk this year on the regulatory front. The U.S. Securities and Exchange Commission (SEC) plans to issue its climate disclosure rule by the end of 2023. In June, the International Sustainability Standards Board (ISSB) issued its first global standards. The European Union issued its European Sustainability Reporting Standards (ESRS) in August. These will be mandatory for large European companies from next year and, in due course, for international companies with European operations. Corporate reporting hasn't changed this much since the SEC was created in the wake of the 1929 stock market crash.

How should senior executives and boards respond to, and take advantage of, these changes? In this article, we explain why focusing on what investors want from sustainability reporting is a critical lens for understanding how to act. Through that lens, we examine how best to navigate the evolving landscape of mandatory reporting.

What do investors need to know?

Investors seeking gains via either growth or lasting value know that the energy sources that built our economy are not those that will sustain it. Economic value will therefore be created by serving new and existing markets in different ways. Investors are looking to these different market conditions that lie ahead, where sustainability builds resilience and increases the capacity for growth.

Smart investors also know that if global warming is not slowed, and if natural resources continue to be depleted at the current rate, economic activity will suffer. Insurers are experts in anticipating and managing risk, and they are ahead of the game, rethinking where and how they do business. A consequence is that the costs of catastrophes related to climate change will increasingly be borne more directly by businesses and private citizens. The summer of 2023 has seen New Yorkers sheltering inside from the smoke of Canadian forest fires, increasing damage from hurricanes in Florida, record temperatures across the southern U.S., and dangerous, damaging flooding from summer rains in the northeast. These are the scouting parties for the effects of climate change; the main forces will be along later.

In this broader global context, investors want to know how you see the future, how you are planning to meet it and what value you expect to be able to create. Current financial

reporting alone cannot offer this; in a disruptive world, investors cannot evaluate your prospects based upon past performance. Investing is making choices. Sustainability informs returns.

This not just compliance, any more than accurate tracking of revenue and expenses is not done purely for the benefit of regulators. Neither is it a PR exercise afforded by selective voluntary disclosures. It is instead the recognition that what is material to sound investment decisions, in a world roiled by wicked, systemic problems, is changing; corporate reporting must change as well.

How Mandatory Reporting Is Taking Shape

For public companies in the U.S., the primary consideration has to be the SEC's forthcoming rule, which addresses investors' demands for climate-related disclosure. At a minimum, this concerns reporting on greenhouse gas (GHG) emissions from the company's directly controlled operations (Scope 1) and from its purchased electricity (Scope 2). More contentious is Scope 3 emissions, which occur as part of the value chain process by which the company makes its money, be that upstream in production of inputs to the company's operations, or downstream in the use of the company's products. The significance of these emissions varies enormously by industry. In some cases, where direct operations involve high emissions, Scope 3 might be relatively low. In other cases, Scope 3 might account for more than 90% of a company's carbon footprint.

Scope 3 emissions are a risk factor from an investor's perspective because a business with a high carbon footprint is relatively vulnerable to transition risks. These can include regulations that restrict (or make more expensive) carbon-intensive products; the loss of business or employees to competitors with stronger sustainability credentials; and reduced availability of finance or increased cost of capital. Equally, a high carbon footprint is an opportunity for transition that reduces these risks, and so increases the valuation of a company in relation to its peers. It is hard to make the case that information about significant Scope 3 emissions is not material to investors. It follows that — whether or not the SEC decides to mandate Scope 3 — companies that have Scope 3 in hand are better placed to be resilient than those that do not. It is inevitable that investors will seek this disclosure and that companies will increasingly provide it.

However, preparation for mandatory disclosure goes beyond keeping track of SEC requirements, as regulators can have extra-territorial reach and because sustainability reporting is inherently global, given international supply chains: data are collected from your suppliers, who will in turn collect it from their suppliers, and so on up the supply chain. For a large corporation, this can easily amount to data from thousands of entities, from many different countries. Good luck aggregating these data if they are not all measured in the same way. Meanwhile, your customers will be requiring sustainability data from you (and you from them, in order to understand downstream emissions). These customers will also be spread across different geographies. They might include unlisted and public sector enterprises because all are part of the value chain of listed companies. You don't want each of them to be asking you to measure different things, using different units of measurement.

It therefore makes sense to align with the global standards of the ISSB, which have been endorsed by the International Organization of Securities Commissions (IOSCO). Fortunately, the SEC climate proposal closely aligns with the ISSB, and the agency “recognized the importance of global alignment and of drawing on existing frameworks that have enjoyed significant voluntary market uptake,” according to Allison Herren Lee, former SEC Acting Chair and Commissioner. The widely-used standards of the Sustainability Accounting Standards Board (SASB) have been subsumed within the ISSB, and both the Task Force on Climate-related Financial Disclosure (TCFD) and the World Economic Forum have formally announced that they will sunset their guidance on climate disclosure and sustainability metrics, respectively, in favor of this work being continued by the ISSB. Meanwhile, CDP (formerly the Carbon Disclosure Project) – the global reporting platform for more than 50% of global market capitalization – will base its future data capture on ISSB standards. Overall, there is a clear direction of travel towards the ISSB setting the global baseline of investor-oriented sustainability disclosure standards that can be used across markets.

In addition — though not immediately obvious — voluntary alignment with global sustainability reporting practice will itself influence the rule making of the SEC. The role of the SEC is to help ensure that markets are supplied with the material information that investors need and to do so in a way that passes a cost-benefit test. Where consensus has already formed around measurement and reporting, costs are lower, benefits are greater and material information is more readily available.

As noted above, business leaders must also be alert to the extra-territorial reach of some regulation. In early September, California passed legislation to mandate climate-related disclosure that includes any outside company doing business in the state and generating more than \$1 billion in annual revenue. Meanwhile, international attention is focused currently on the EU, whose mandatory reporting requirements (ESRS) come into effect in 2024 and will shortly thereafter apply to corporations headquartered overseas but with European operations. The ESRS requirements are far deeper and broader than the SEC’s are expected to be. There are 12 standards, covering in detail a range of environmental, social and governance disclosures. And the scope of ESRS extends to “double materiality,” which means reporting not just to investors but also on issues material to all other stakeholders.

Step Up to Meet Demands for Rigorous Sustainability Reporting

As mandated corporate reporting expands to include sustainability issues, the following guidance can help you develop a plan to build the necessary capabilities.

1. *Don’t stop what you’re already doing.* You may be doing sustainability reporting in some form already, applying SASB, TCFD or the Global Reporting Initiative (GRI), and/or reporting to CDP. You will need to build on these practices, but you are on the road already.
2. *Don’t let perfect be the enemy of good.* In the realm of voluntary disclosures, what investors want is whatever you can reasonably provide. Keep in mind that sustainability data are only indirectly relevant. Investors don’t want to know your GHG emissions so much as they want to know how the presence of these affects your financials. For that purpose, reasonable estimation of emissions is typically good enough and, by such means as using industry

averages, it is generally not hard to achieve. You should be careful to communicate the basis of your estimation and you should not overstate the confidence you have in measurement. Take advantage of safe harbor provisions, as appropriate. What your investors don't want is nothing, which would convey either that you are not transparent or that you do not have material information about your business, or both. Either would be a good reason for investors not to invest.

3. *Align with financial reporting.* If your sustainability report is separate from your financial reports and investor presentations, then you are missing a trick. Investors want to understand how your sustainability-related position and performance affects your financial prospects. The more you can express your sustainability-related metrics and targets in the language of finance, the better. For example, it is one thing to have a target for net zero GHG emissions, but another to set out a transition plan that quantifies the capital expenditure that will be required and that guides investors in understanding current and prospective income statement effects.
4. *Focus on climate, be ready for the SEC.* Because climate is the dominant sustainability issue, emissions are appropriately the focus for SEC regulation. If you are not on top of climate-related reporting already, at some point you will need to be, including being ready to have your data audited externally. Moreover, climate is most likely your best starting point in sustainability reporting. It affects all companies, measurement practice is relatively established, and market understanding is relatively high. And if you can do climate reporting well, you will have built the capabilities needed for most other aspects of sustainability reporting, ranging from relationships and data systems throughout your value chain, to the art of translating sustainability data into financial implications for evaluation by your investors. To have this foundation you will need to extend your data and control systems beyond your directly controlled operations, because your sustainability performance can only be understood in a value chain context. You should therefore develop your (material) Scope 3 GHG emissions reporting, regardless of whether it is mandated by the SEC. This will become easier once there is widespread Scope 1 and 2 disclosure.
5. *Tighten systems and controls, throughout your value chain.* As sustainability reporting evolves from being voluntary to being mandatory, you should expect greater influence and control from your finance and legal functions, as ownership of sustainability reporting migrates away from existing homes such as communications, external relations and dedicated sustainability teams. This migration will come with a higher hurdle for systems and data quality, and so almost certainly it will mean additional costs. But, as ever, focus on the business case, which means thinking benefits as well as costs. A comparison with financial accounting is again insightful. Your finance function is expensive. Maybe too expensive, maybe it could be more efficient. But is anyone suggesting your company would be better off without it? No doubt there was pushback on cost when the SEC first introduced disclosure requirements. But then the world moved on, and the net benefit from reporting has become well understood. The same is true for sustainability reporting. If you build an authentic sustainability story, the benefits will exceed the costs. In addition, and related, you should stay ahead of the curve. In a world of satellite data and AI, your sustainability performance will increasingly be reported *to* you rather than *by* you, for which the best legal and reputational protection is to be in control and transparent. Don't allow

your sustainability story to be apologetic, a response to breaching the conditions of your social license to operate.

6. *Align with the ISSB global baseline* (and require your supply chain to do likewise). Your regulatory obligation is determined by the SEC. There is little reason to expect the SEC's investor-oriented focus to diverge from that of the ISSB. Yet there is good reason to expect regulation to become tighter, faster in major jurisdictions elsewhere in the world. You operate in a global economy, where benefits for investment decisions are greater, and costs of gathering reliable data lower, if all share the same measurement and disclosure standards. Aligning with the ISSB is the most effective way to align with the SEC while also reducing costs and improving data quality.
7. *Use ISSB as a baseline for ESRS*. The fundamental difference between ISSB and ESRS is that the former requires reporting to investors (consistent with the SEC), while the latter also requires reporting on issues that are material to all other stakeholders. If your operations draw you into the extra-territorial reach of ESRS, your optimal response is simple. Do what you would anyway do to report in the US and globally to your investors, and then separately add the additional disclosures required for ESRS compliance. The ISSB and the EU will jointly be issuing guidance on how this two-step reporting can best be done.
8. *Contribute to the development of industry norms*. Sustainability issues vary by industry. Companies are categorized by industry in the capital markets, to better enable like-for-like comparison and to analyze shared exposures to industry-specific risks and opportunities. This is why the SASB standards are industry based and why the ISSB has likewise committed to this standard-setting approach. Given that industry expertise sits within the industry and sustainability reporting remains a young practice, companies should participate proactively in discussions on best reporting practice in their sectors, directly and indirectly helping to shape future standards.

Conclusion

Above all, ensure that your sustainability reporting has an authentic connection with value creation. If it feels like an exercise in compliance, then your company is missing opportunities. There should be alignment between information that is valued by your investors and that which is valuable to you in leading the business. Investors may see the firm as at greater risk of being left behind in a rapidly changing and increasingly perilous world, and your reputation in the marketplace may suffer. Consider instead how a willing embrace of tracking and disclosing sustainability performance can not only win support from the market, but also, via focus and accountability, help you manage your company through the profound transitions that planet and society demand of us all.

About the Author: Richard Barker is a full-time member of the International Sustainability Standards Board, on leave from the Saïd Business School, University of Oxford. This article expresses the personal view of the author, not the official positions of the ISSB.

