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SUSTAINABILITY REPORTING: WHY BOARDS SHOULD CARE

April 2, 2019 By Jim DeLoach

A recent survey of more than 500 public company directors noted that although environmental, social, and governance (ESG) issues are currently a relatively low priority for many boards, most directors would like their boards to become more proactive and enhance ESG oversight. Specifically, 53.6 percent would like their board to improve its understanding of the company's current levels of ESG-related performance, and 49.8 percent would like to ensure ESG issues are strongly linked to the company's strategy. This growing interest is likely due to increased shareholder activism evidenced by high-profile proxy battles over ESG-related topics and institutional investors proactively assessing ESG performance of companies in their portfolios.

We often hear the assertion that corporate leadership is needed to enhance civilization's ability to address a litany of critical social concerns. More often executives are called on to address environmental, economic, and social challenges, and enable the general welfare of present and future generations. While this may be a vague assertion to some, the reality of ESG criteria is that the concept offers powerful differentiators for screening investments and grounds the discussion in ways that can't be ignored in boardrooms and C-suites.

The above research suggests that the CEO's level of interest is crucial for companies to progress from passive interest in ESG to an action-oriented perspective about sustainability issues.

With that critical transition in mind, two important developments to watch are offered.

• Further evidence sustainable investing is on the rise.

Sustainable-, responsible-, and impact-investing assets have expanded to $12 trillion in the United States, up 38 percent from $8.7 trillion in 2016. Much of this growth is driven by asset managers considering ESG criteria across $11.6 trillion in assets, up 44 percent from $8.1 trillion in 2016. The top issue for these asset managers and their institutional investor clients is climate change and carbon emissions. From 2016 through the first half of 2018, 165 institutional investors and 54 investment managers controlling $1.8 trillion in assets under management filed or co-filed shareholder resolutions on ESG issues.

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• Evidence of responsible investing emerging as a source of outperformance.

A recently released study by an asset management company noted that during the period from 2014 to 2017, responsible investing was generally a source of outperformance in both the Eurozone and North America. In the Eurozone, all ESG pillars and ESG score integration displayed positive returns, with the governance pillar dominating. In North America, ESG investing during this same period (2014 to 2017) also displayed positive returns, although the environmental component was the biggest winner. The study also noted that the massive mobilization of institutional investors regarding ESG investing in Europe has impacted demand mechanisms, with a consequent effect on prices, thereby triggering a performance premium.

These two developments warrant close attention. The world is changing and investors are taking notice. That alone directs equity market focus to companies committed to sustainable performance largely because they are demonstrating an ability to adapt to changing business realities.

In addition to the previously mentioned developments, key factors follow for interested companies to monitor going forward.

• Competitors issuing voluntary reports.

As more companies report voluntarily, peers must consider whether to follow suit. The Sustainability Accounting Standards Board (SASB) provides useful examples of companies reporting in accordance with its standards to illustrate the transparency and impact of such reports on risk management, long-term performance, and brand image.

• US Securities and Exchange Commission (SEC) mandates.

The SEC has been petitioned to standardize and mandate ESG disclosures through rulemaking. However, to date the Commission has been content to let market forces determine what issuers report.

• Attestation of selected sustainability information is increasing.

Attestation has a long way to go in North America as it continues to lag behind the European Union in the number of externally assured reports. Voluntary use of attestation services is a key factor to watch.

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• Pressure from activist shareholders.

Pressure comes in many forms. For example, activists apply pressure on boards to change their composition and management incentives in the proxy process. They use ESG screening criteria to drive investment decisions within their portfolios. Institutional investors (e.g., BlackRock, Vanguard) are communicating pointed messages to boards and CEOs regarding the importance of ESG-related issues. It bears watching their actions closely to see if their bite matches their bark.

• Convergence of frameworks.

Because the SASB standards are tailored specifically to U.S. companies and SEC filings, it is likely that they will continue to gain traction in the United States. But there are other frameworks in use. The SASB, Global Reporting Initiative, and International Integrated Reporting Council have announced a two-year project to collaborate on standardization of sustainability reporting frameworks, as well as on frameworks that promote further integration between nonfinancial and financial reporting. Progress on this effort to harmonize frameworks and metrics can raise the level of investor interest.

• Disruptive industry developments.

Dutch Royal Shell's decision to tie executive pay to carbon emissions is an example of an industry-first commitment to link incentive compensation to climate change. The automobile industry also is investing heavily in hybrid and electric cars, and its attendant effects on the oil and gas and power industries is another example of pending disruption.

Exactly how the future of sustainability reporting will unfold remains to be seen. Voluntary reporting and submission to attestation, coupled with pressure from activists and the convergence of global reporting standards, will provide a powerful mix of forces that could move the meter in many boardrooms and C-suites.

The eight key factors listed above bear monitoring by your board going forward, as new developments could nudge boards and chief executives toward improving the relevancy and transparency of sustainability performance to investors.

Ref:
https://blog.nacdonline.org/posts/sustainability-reporting