



WHITE PAPER | GCM COMPLIANCE RISK FACTORS

Disclosure of Environmental, Social, and Governance Risk Factors: Transparency or Greenwashing?

—

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Financial Executives Research Foundation

Foreward

The audience for environmental, social and governance (ESG) issues is changing. Are your disclosures keeping pace with your audience's evolving needs?

As ESG takes center stage, both in the U.S. and globally, this latest disclosure frontier is becoming one of the most important areas for public companies to watch. Increasing regulatory and stock exchange requirements and investor demands, as well as the introduction of more and better disclosure frameworks, are all helping drive this change.

To keep up, CEOs, CFOs and public company boards are looking for ways to identify where ESG risk factors play a role in their investor communications and also in the long-term strategy of their companies.

“Corporate social responsibility,” “corporate citizenship,” and “sustainability” are all common terms used in the current discourse on how the reporting environment is — and should be — changing. Today, the central challenge is meeting investors’ demands for ESG disclosures that are “decision useful,” moving away from merely providing boilerplate language to furnishing quantitative, transparent data aligned with materiality and company-specific risks and opportunities.

To help facilitate consistent disclosure and integration of material, company-specific factors, a number of ESG standard proposals have emerged. Starting in 2006 with Principles for Responsible Investment (PRI), ESG issues began their evolution into mainstream investment practice. Additional standards-based organizations like the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB) are offering ESG disclosure frameworks

so global corporations can provide investors with relevant information on critical sustainability issues, among them climate change, human rights, corruption and best-in-breed governance practices.

The following research is based on interviews with ESG subject matter experts who identify ESG risk factors related to transparency and materiality of corporate disclosures. Among the more interesting findings is that a corporate social responsibility (CSR) report no longer equates with having a truly sustainable business strategy. Another is that big data will soon transform ESG in ways that are difficult to fully envision at the present time.

Recent research by Donnelley Financial Solutions (DFIN) and SimpleLogic published in their 2015 Canadian Investor Survey reveals a gap between the ESG information public companies are disclosing and what Canadian investors truly want to know. Those Canadian institutional investors surveyed note they are turning to third parties to delve into ESG issues for the companies in which they're investing. Specifically, only 30 percent of investors found the ESG information public companies provided was sufficient to help them assess materiality to the company's business.

Our current research on ESG disclosures represents an important step forward in identifying gaps in what issuers are reporting regarding ESG and the information investors are actually using when making investment decisions.

From these interviews, we get a glimpse at the future of ESG as it evolves from a check-the-box exercise to a critical disclosure vehicle for supplying investors with decision-useful, quantitative factors aligned with corporate risk, materiality and long-term strategy.



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Executive summary

As a growing number of companies increase voluntary disclosures about ESG risks, investors and regulators are evaluating whether enough information is being provided.

In April 2016, for instance, the U.S. Securities and Exchange Commission (SEC) published Concept Release 33-10064, “**Business and Financial Disclosure Required by Regulation S-K**,” which addresses risk and risk management. Noted in the release was the potential for inclusion of ESG risks when materiality is an issue.

To help senior finance leaders in understanding how ESG risk disclosures affect the perception of, and potential investment in, their organizations, Financial Executives Research Foundation (FERF) interviewed subject matter experts from a variety of industries for this report. The study, produced in collaboration with DFIN, aims to bridge the gap between the ESG information companies are currently disclosing with what investors and other key stakeholders want to know.

Some of the key findings include:

- Investors want ESG information and are obtaining it from many different places.
- Having a sustainability program and/or producing a CSR report are not the same thing as having a sustainable business strategy.
- Companies need to take a leadership role and determine the most important sustainability and ESG issues for creating long-term value in their businesses.
- Big data is about to collide with sustainability and ESG to a large extent.

Introduction

The desire for additional ESG information falls within a broader appreciation of the value of an organization's marketplace reputation.

Warren Buffet once said, "It takes 20 years to build a reputation and five minutes to ruin it." Whether we're talking about the BP gulf oil spill, the Volkswagen emission scandal, or the Mylan Pharmaceuticals EpiPen price increases, when it comes to reputational risk, the list of companies that have found this out the hard way continues to grow.

Furthermore, "The Economist" noted, "Companies with their eye on their 'triple-bottom-line' outperform their less fastidious peers on the stock market." Originally coined in 1994 by John Elkington, the 'triple-bottom-line' (or TBL) is an accounting framework that consists of three parts: social, environmental and financial. Some companies have implemented the TBL framework to evaluate their performance in broader terms to build greater value.

A recent **Label Insight** study found 94 percent of consumers said that they would be more loyal if a brand promoted complete brand transparency. "Simply put, transparency has positive implications for brands — fostering product loyalty, brand loyalty and increasing the product's worth in a consumer's mind," the study says. "In an age where consumers are more concerned about what's in the products they use and consume than ever before, brands that provide shoppers with the information they seek through their preferred channels will reap the benefits."

Within this environment, the SEC is taking another look at corporate disclosures. As a part of its broader **Disclosure Effectiveness Initiative**, which is meant to review existing requirements and the disclosures companies make to investors, on April 22, 2016, the SEC issued **Concept Release** 33-10064, "Business and Financial Disclosure Required by Regulation S-K." The release — which seeks comment on virtually all Regulation S-K provisions applicable to U.S. reporting companies — includes 11 pages of discussion on sustainability disclosures.

The SEC is asking whether current disclosure requirements continue to provide the information investors need for investment and voting decisions, and how companies can present this information most effectively. Additionally, costs and benefits of disclosure requirements for companies and investors will be considered.

Environmental, social and governance risk

While many independent organizations are proposing guidelines and standards for jurisdictions worldwide, this report focuses on underlying ESG risks and how to disclose them most effectively.

A **McKinsey & Company** article “Sustaining Sustainability: What institutional investors should do next on ESG” reports that “... many institutional investors have publicly committed themselves to integrate ESG factors into their investing. The UN-backed Principles for Responsible Investment (PRI) have been signed by more than 1,500 investors and managers, representing nearly \$60 trillion in assets under management.”

As Oxford Saïd Business School professor, Dr. Bob Eccles, who is also chairman of Arabasque Partners Asset Management, the world’s first ESG Quant fund, pointed out, “Right now in the investment community, it’s game over. The big asset owners and asset managers realize the value, even necessity of ESG integration. The lag is more on the corporate side where confusion continues to exist between a company’s sustainability strategy — which is their carbon emissions, water use, waste and contributing to the community — and the material issues which contribute to a sustainable corporate strategy.”

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DR. BOB ECCLES
CHAIRMAN, ARABESQUE PARTNERS

“We need to distinguish between what is material and what is socially significant. Material issues must be addressed in the company’s strategy and these are based on who the board believes are the significant audiences, including investors. Socially significant issues are those that matter to other important stakeholders but which are not critical to the company’s success. Since the board’s fiduciary duty is to represent the interests of the corporation — not just investors as is commonly believed — the board must make this judgment.”

“The board must decide, for example, if the role of the corporation is to serve the interests of short-term shareholders or if there are other significant audiences where longer time frames are more important. The board can choose either one. I just think it needs to be clear about this choice and to communicate this to investors and all other stakeholders. They, in turn, will determine if and how they want to engage with the company.”

Transparency plays a major role in driving increased investor interest in ESG topics, says Rob Wilson, research analyst at MFS Investment Management.

“Suddenly we now have a lot of additional information in many different areas, whether it’s climate or elsewhere, that can help us better understand the future of the companies we’re looking at and we can now model and value some of these ESG factors. In the past, we really didn’t have the data to be able to do that in a confident way,” Wilson says.

MFS Investment Management, Head of Global Institutional, Carol Geremia adds, “As investors, we’re focused on identifying companies with long-term, sustainable business models. And more often than not, you can determine whether a company is truly focused on creating long-term value by looking at its approach to key ESG issues.”

Wilson added, “I think by and large you find many longer-term investors who are questioning this whole idea of putting the shareholder first. Is that right? I think a lot of companies have become so short-term oriented that they think that’s the only stakeholder view to consider. But the executive who’s truly thinking about the long-term health of their business is definitely going to be thinking about customers and employees and all of their stakeholders — and that’s how you run a good business over the long-term.”

A number of large enterprises are currently making a variety of ESG disclosures, says Eric Hesperheide, interim chief executive of GRI (formerly the Global Reporting Initiative).

“If you parse the upper end, the Global Fortune 100, or even the S&P Global 250, those very large companies, by and large, are very much attuned to sustainability issues and reporting, and are actually internalizing it into their decision-making and understanding that there’s something more to decision-making than just the historical financial perspective. When you consider the S&P 500, I think we’re up to about 88 percent that are doing sustainability reporting, and most of them use GRI disclosures.

“In my discussions with many of them, they, not all to the same degree, increasingly recognize that these ESG risk factors are critical to their long-term success, so they’re incorporating these considerations. Now when you get down below the really big, global companies, and certainly companies that are principally focused in U.S., there’s a very significant drop-off in not only the amount of reporting, but also the recognition that this is an important, emerging consideration for long-term corporate success. That’s where you start to see this difference between Europe and the U.S.

“Now, I think it’s changing but it’s changing very slowly in the U.S. Outside of the U.S., you have a number of jurisdictions where government policy makers or regulators or both, are stepping up and requiring some form of disclosure. If a regulator or policy maker says, ‘You should disclose this’, it ought to be a pretty good signal that at least the government or regulator thinks it’s an important consideration, so the company should do more than just report on it, they should act on it.”

Materiality

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In terms of how companies begin to undertake deciding what ESG risks to disclose, outgoing SEC Chair Mary Jo White has said, “Timely, relevant and material information is critical to investors and companies. The concept release (33-10064) establishes a thoughtful framework for better understanding investors’ and companies’ experiences with the disclosure requirements and whether investors are receiving the information they need to make informed investment decisions.”

Again, the June 2016 McKinsey & Company article “**Sustaining Sustainability**: What institutional investors should do next on ESG” says: “... investors have struggled for some time to determine which ESG concerns are relevant to particular investments. In response, some leading institutions have embraced the idea of ‘materiality,’ derived from the concept of material information in accounting. Much as knowledge that could influence investors’ decisions is deemed material, so too are ESG factors that will have a measurable effect on an investment’s financial performance.”

Michael Piwowar, SEC commissioner since 2013, noted: “It is not sufficient that information merely be useful. Nor is it sufficient that only some investors might find a bit of the information to be important. Rather ... the question of materiality ‘is universally agreed as an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor.’ Thus, materiality is an objective legal standard, not a subjective political one.”

“I don’t necessarily ascribe to the idea that social and environmental issues and those types of risks should be in a [Reg] SK business or financial disclosure requirement... To try to incorporate those types of items into an SEC filing, and then subject that to outside legal review and update, in my view, it’s not appropriate — unless there’s a direct financial implication.”

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With respect to materiality, Arnie Hanish, retired VP and chief accounting officer at Eli Lilly and Board Member at Omeros Corporation, notes, “My exposure to these kinds of risks that tend to manifest themselves in sustainability reporting tend to be more around social issues.

What is the company doing with regard to the social environment today? My perspective is that yes, there is some potential financial risk. If there are environmental issues where a company has not been appropriate and diligent in its dealing with waste or disposal of waste as an example, those could certainly have financial costs. The things that I'm more experienced with are those things that tend to have more social outcomes to a company. How do you deal with that from a risk and a risk management perspective that could potentially impact your reputational risk?

"I don't necessarily ascribe to the idea that social and environmental issues and those types of risks should be in a [Reg] SK business or financial disclosure requirement unless there is a clear financial risk. The MD&A and disclosure filings today are so voluminous to begin with. To try to incorporate those types of items into an SEC filing, and then subject that to outside legal review and update, in my view, it's not appropriate — unless there's a direct financial implication."

Investors differ on their perception of materiality and the value of ESG disclosures.

Rob Wilson says, "I'd be looking for clear disclosure in current financial statements. The big issue right now is you have these very long corporate sustainability reports which are intended for a wide group of stakeholders. Generally, because of that fact they are not overly helpful to investors and contain information on a wide range of issues or topics that a lot of investors wouldn't view as overly material from a financial standpoint, the reports are very difficult to efficiently work through. There is a lot of text and information and not many data points."

Carol Geremia notes, "As an investor you're really trying to get underneath all that and look at what is material to the success of the business. I would also add, there's a lot of convergence around ESG and the idea of the war on short-termism. One way is by building metrics into the business to run it with a longer term view which helps avoid short-term pitfalls. This ultimately ties right back to sustainability and ESG factors."

On the question of what issues are considered material, an anonymous senior equity analyst with an institutional investment management company comments, "I think that forces a broader discussion. Now there's a legal aspect that we need to consider whether it's material or not and disclose it. From an investor standpoint, we only look for material things to begin with, whether it be material events that a company discloses in their 10-K or whether it's things the market is saying. Where does it go from here? Definitely, with those regulations coming on and having to legally disclose material aspects of [ESG], it's only going to get more and more robust, I would think. It will be your larger-cap companies that drive the narrative. Time has proven, whatever they end up doing, the others eventually follow, because their investor base begins to have more expectations."

"In the last two years, the investment community is really getting pretty serious about wanting to know what the company deems to be material and for it to provide performance information on these issues," says Dr. Eccles. "In the U.S., Regulation S-K says the company should report on all material information in Form 10-K. It doesn't specify that this is financial information only, or even quantitative information. If an issue is material, it belongs in the 10-K and if there is a metric that can be provided it should be."

“But it’s not just the 10-K that’s important. It’s all the other ways in which a company communicates with its investors, like quarterly calls and annual meetings. The common complaint of companies is that investors don’t give them any credit for what they are doing on sustainability. But if you look at these presentations there is virtually no information on this. What are the material ESG issues? How are they being measured and managed? How do they affect financial performance? These are the elements of a sustainable corporate strategy.

“Just as companies need to make the business case for mergers and acquisitions, for investing in new products, for entering new markets, etc. they need to make the business case for their sustainable strategy. Investors want to hear about this, so companies need to learn how to talk about it.

“On this point CFOs are often the gating factor. They aren’t comfortable with talking about the material ESG issues and explain their relationship to financial performance. Admittedly the data quality for ESG issues isn’t the same as for financial information. Admittedly the relationship between ESG and financial performance isn’t always well defined. But these limitations shouldn’t be used as excuses for not going anything. I think companies have no choice but to get started and they will get better at this over time.”

Eric Hespenheide points out a specific conundrum for very large companies — what is financially material?

“This gets into this debate, which will continue to go on because there’s no easy answer, as to how you define materiality in a governance context, and how do you define materiality in some of these environmental and social contexts.” Hespenheide says.

“That’s the strength of GRI’s approach to materiality, which is based on a robust and inclusive stakeholder engagement process that allows companies to understand the various different perspectives, and to be able to classify something as ‘material’ from an individual stakeholder perspective. This is not necessarily the same as being financially material. That’s the conundrum I think we have. People often talk about materiality as if it’s the same thing across all dimensions, when, in fact, materiality is highly contextual.”

Closing the disclosure gap

According to DFIN's 2015 Canadian Investor Survey, a gap exists between the ESG information companies are disclosing and what Canadian investors want to know. The study also shows a link to risk and business strategy, as well as operational risk and financial performance, demonstrating the importance of materiality as it relates to ESG.

“No company would ever come to us and ask “what should my strategy be? That would be a huge red flag that this management team doesn’t know what’s going on. Why should it be any different for ESG related issues, unless the management team or the board really just doesn’t get it?”

**ROB WILSON RESEARCH ANALYST,
MFS INVESTMENT MANAGEMENT**

Canadian institutional investors do consider ESG issues when making investment decisions. In fact, investors are using ESG information in several ways and are mostly getting this information from third parties. However, many times the third-party information simply is not giving them what they need.

However, as a senior equity analyst with an institutional investment management company points out, “ ... there is an inherent bias in that, because investors want all the information they can get as it helps their investment thesis.

“[When it comes to] significant social and environmental events, I’m sure negative events happen all the time. It’s just a matter of: Does it impact the P/L? When it comes to investors, as long as it does not negatively impact the investment thesis and doesn’t impact the P/L, I think people, at least in their day-to-day job, turn a blind eye to some of that stuff unless it poses a risk of sentiment or negative publicity.”

When it comes to what types of information investors want, this question is something Arnie Hanish has been wrestling with for years. “Regardless of whether it’s ESG reporting, or just general reporting, investors tend to want everything. The real issue is: What information is truly going to have an impact on shareholder value and on the value of the enterprise?”

“The analysts kept asking for this information. We weren’t measuring ourselves that way, and they kept telling us, ‘Your competitors are doing it this way, and you’re an outlier.’ Who’s right and who’s wrong? In my view, much of this is really around reputational risk and you could have discussions in the 10-K around something that could impact your reputational risk.”

Eric Hespeneide notes, “There are all sorts of investors. Part of the problem is, investors, to use the generic term, have not been particularly clear

on what it is they want to know. If they were more clear and if there was at least semi-uniformity in terms of what all these different types of investors are looking for, then groups like ours would have an easier time incorporating those information needs into our reporting standards.

“I’m not convinced that investors have been particularly forthcoming or in agreement amongst themselves as to what it is they think is important for companies to disclose, from an ESG standpoint. That creates part of the confusion or problem that companies have in terms of this potential mismatch between what they’re disclosing and what investors say they want. At GRI, one of the things we do, as we develop standards, is we reach out to all types of stakeholders, including investors. We ask them, what issues they care about in terms of what a company is or isn’t doing?”

Rob Wilson remarks, “I think the way companies need to go about doing this is frankly just to assert their leadership position. What I find really interesting is that I’ve had a lot of companies ask me; what do you want us to disclose?”

“No company would ever come to us and ask “what should my strategy be? That would be a huge red flag that this management team doesn’t know what’s going on. Why should it be any different for ESG related issues, unless the management team or the board really just doesn’t get it?”

Carol Geremia agrees, “They’re just falling into the typical trap by saying I’ve got to give investors what they want. There is very little leadership from that perspective.”

Wilson continues, “We responded to the SEC’s recent Reg. S-K concept release and our position is that companies should take a leadership role and

focus on what they think are the most important sustainability and ESG issues for creating long-term value in their businesses. They should identify things they think are material to their organization and provide information on those issues in financial statements and on analyst calls. When you’re doing your quarterly call, provide that information in your prepared remarks because then you’ll get people talking about it. More firms should take that leadership role when they’re setting their ESG strategy.”

When asked whether he thought the recent ESG-related issues of BP or Volkswagen might persuade skeptics as to the importance of ESG risk disclosure, Wilson said, “I think that only works to a certain extent. A more effective method to create change on this issue is through logic. You do it through quantification, and you do it through rigorous analysis. Instead of ‘Don’t show up on the cover of the Wall Street Journal,’ take a look at how this issue is impacting your earnings in this way. That’s what CFOs and CEOs respond to and that’s what investors respond to.”

Dr. Eccles notes, “A lot of sustainability reporting, the way it’s currently done, some of it is green-washing.

“What companies should be doing is saying, ‘We think this is fairly important. We don’t think it is material for us but we’re going to report on it; here’s the data. Make it easier for them to find ... If you’re talking to your investors about this stuff because you think it’s either helping you minimize risks or create opportunities, that’s material for the 10-K from the U.S. context.

“From Arabesque Partners’ point of view, right now we’re basically relying upon third-party data methods, because the problem is companies are not reporting on this stuff.”

ESG risk disclosure best practices

While companies and investors may still have a way to go in closing the gap, some companies have been taking steps and making significant strides in ESG risk disclosure. Carol Geremia highlights, “I’ve been on the road recently giving a presentation to investors called, ‘Not Everything That Counts Can Be Counted.’ The idea is to help investors start thinking about how they are evaluating managers with a long-term view because it all trickles down.”

A recent Fortune article referenced how, “Many CEOs and CFOs think Wall Street will punish them for quitting the guidance game.” Geremia doesn’t think so. “If you want investors to stop focusing on your quarterly results, step one is to stop predicting them. Unilever CEO, Paul Polman, stopped giving quarterly guidance in 2009, and ‘bluntly told investors that if they didn’t buy into this long-term value creation model they should take their money elsewhere.’ The article went on to say the stock has nearly doubled since then. So when Polman basically told Wall Street he wasn’t going to provide quarterly guidance, the general consensus was that this would adversely affect the stock price. Ironically it didn’t and that was the whole point of the story. On top of that, Berkshire Hathaway CEO Warren Buffet has never given guidance of any kind and his record is hard to argue with.

“It’s really about spending more time on reporting the stuff that matters and getting away from all the insanity of reporting on short-term issues that are preventing companies from running their businesses the way they should be.”

CAROL GEREMIA HEAD OF GLOBAL INSTITUTIONAL, MFS INVESTMENT MANAGEMENT

“I think some analysts might not appreciate this. But, I think it’s really about spending more time on reporting the stuff that matters and getting away from all the insanity of reporting on short-term issues that are preventing companies from running their businesses the way they should be. I think the integrated summary report that GE did and Atlas Copco have put out, and the changes they’ve made to their annual reports have gone a long way toward integrating material ESG issues that you don’t typically see from most companies. That’s really best practice.”

Arnie Hanish comments, “When I was at Eli Lilly, we had to deal with some issues related to marketing practices, which had an impact from a reputational perspective risk, but it also ultimately had a financial impact to us.” He points out that Eli Lilly disclosed actions undertaken by the SEC and the Department of Justice very early in the process.

“We had disclosures in our filings about this long before anything became ‘truly material; because we felt it was appropriate to alert our investors that there was an investigation taking place which could have certainly had an impact on the company’s reputation,” says Hanish.

Eric Hespenheide remarks, “That’s the way we’ve developed our standards, asking what’s the issue we are trying to solve? What information are stakeholders, including but not limited to investors, looking for? Then how would we demonstrate what a company’s impact is on that particular issue? We’re striving to get away from the generic, tell me everything that you’re doing about climate change type of disclosure. Depending on the company, or the sector, that’s a pretty broad-based question.

“I think companies that actually are doing a good job are the ones that take it seriously, and by that I mean that these issues get the attention of the C-suite. They take seriously their evaluation of the broad set of stakeholders that they impact; meaning civil society, communities in which they operate, labor’s point of view, which are sometimes contentious, particularly if it’s a unionized environment. Nevertheless, they have a legitimate view on what’s going on.”

Dr. Eccles recalls, “I had a discussion with a CEO and his direct reports recently about sustainability and a sustainable strategy. They immediately got the distinction between the two. If the company decides this sustainability stuff is not that important and it’s not really material, and none of it is part of a sustainable strategy, then just admit it. Just say we’re going to have a sustainability report that we’re going to use because we want to be responsive to stakeholders but we’re not going to have the same kind of quality in internal control systems, because we don’t want to over-invest in that. I think that’s fine. That’s the board’s call to make.”

On the other hand, he says, “If you think these things are material, then why wouldn’t you want to have the same quality data and the same quality systems? This argument of ROI, it’s more money, more systems, more staff. That’s the price of doing business. Companies don’t complain about it when it comes to financial data because they’re forced to [spend money], right? You have to have a financial report. You have to have an audit. I’m coauthoring a piece now that basically says you can do an audit of the MD&A. That’s where you could say from a Reg. S-K point of view, the material ESG issues are being reported.”

He continues, “In other words, you can’t say, ‘There are certain things that are really important and key for investors,’ and then turn around and say, ‘We’re not going to report on that stuff all that much because we really don’t want to invest in the systems to generate the data.’ You can’t have your cake and eat it, too. If it’s important, you’ve got to have the same quality control around it as you do with financial data. And if it’s not important, then just admit that it’s not.”

Based on his experience, Dr. Eccles says, “Leading-edge practice is Atlas Copco. They’ve got what I call a sustainable value matrix that makes it very clear on what’s material versus what is decidedly significant. It’s been done. It can be done.

“Financial executives — and they’ll need the support of the CEO, and the board has to be ‘on-board’— they must identify the material issues, and distinguish between the company’s sustainable business strategy and its sustainability strategy. Integrated reporting is one thing. It is a complement to sustainability reporting. The material issues and relationships between financial and non-financial performance become part of your conversation with investors.”

The future of ESG and risk

Changing demographics in the world's working population could have a serious impact on the how companies drive value and create profit in the near future. So what's next? Where do we go from here? Carol Geremia remarks, "I'm not sure it is even going to be called ESG anymore. I think in the next three to five years it may not even have a specific name anymore. Enough asset owners are going to be pushing the idea of longer-term horizons that there will be a re-titling of what sustainable, responsible investing really means and these issues will not be ignored."

"I think this will be evolutionary. I'm biased on this point, but I think that we've got an issue with the 'passification' of capital. This idea that you don't have to care about the price you pay for a business and you don't have to care about what the management is doing because you're an investor that's simply just buying the index — and that's not okay."

Arnie Hanish notes, "It depends on the nature of the risk and event itself that will ultimately drive the amount of reputational and possibly financial impact, which then leads to an evaluation of the amount of disclosure and where it will appear in the SEC documents."

"If the reputational risk or these other issues could have a material impact ultimately from a financial standpoint, then there's probably some reason to believe that maybe you should have some disclosure around it."

ARNIE HANISH
RETIRED VP, CHIEF ACCOUNTING OFFICER
WITH ELI LILLY AND BOARD MEMBER AT
OMEROS CORPORATION

Eric Hespenheide says, "Let's look at the VW situation. I'm not an attorney but let's face it, they committed outright fraud." He goes on to say that because a company commits fraud, ESG disclosures are worthless is an unsound argument. "We never say the same thing when a company commits financial fraud. We don't say, 'Throw out U.S. GAAP, it's worthless, it's just greenwashing of a financial nature because clearly there's something wrong with our financial reporting system because this fraud happened.'" He notes that too many people are failing to accept that standardized and appropriate disclosures of ESG exist.

Hespenheide also noted the sustainable development goals (SDGs). Unlike the millennium development goals, the SDGs had more input from business.

“The actions that came out of the SDGs are more digestible by businesses and by sectors and industry groups because there are specific actions.”

Dr. Eccles notes, “What companies are going to start running into is investors saying: ‘Do you agree with the status of standards or not, and what do you think is material? We would like information on this.’ They’re going to start getting investor pressure.

“This is happening. Investors want it and there’s big data applications that are out there meeting investors’ needs for this data. It is in your self-interest to report on this as well, so it’s your data. Investors are still going to look at this other stuff, but then again it goes back to your need to be very clear on what you think is material, and why, and how it’s related to financial performance. Here’s the metrics and they’re the same quality. That’s how I see this evolving over time.”

Dr. Eccles doesn’t believe the U.S will fall behind versus the rest of the world with respect to ESG because investment community probably won’t let that happen. He says, “I think the fallouts could be more for CEOs and CFOs that don’t get this. They might get replaced quicker now than they would otherwise, and then those that don’t have these capabilities aren’t going to get these jobs anymore. Ten years ago, you didn’t have to care at all about sustainability to become the CEO. Now you probably had better. It’s not quite there yet with the CFOs, but it’s going to happen.”

Conclusion

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The focus on risk disclosures and ESG will continue to gain traction and evolve in the future as demographics and attitudes change. There is an expectation today around transparency.

As Dr. Eccles puts it, “You are either on the bus or under it. This is happening. Investors are embracing ESG in their investment decisions. Financial executives have two choices. They can get out in front of this; they can drive the bus and be proactive with investors and they can work with their boards and specific audiences and focus on material issues, or they can get run over by the bus, because it’s already happening. The front line is not the sustainability people; it’s the chief financial executives. They’ve got to get over this thing of thinking sustainability as just ‘green stuff.’”

However, this is not simply an issue of producing more data for the sake of having more numbers. As Carol Geremia notes, “It’s the same thing we’re saying to investors these days. Sorry to say this, but this will lead to a false comfort that you’re managing

risk better by having a lot of data. But most of this is short-term data and it’s not going to help you identify the bombs that are waiting to go off. It’s hard to think about doing things over long periods of time. It’s hard to make business decisions that go against the grain, but when you think about the best businesses in the world, it’s almost always those that take a counter cyclical view.”

Eric Hespenheide sums up the overall importance of ESG disclosures, “The issues in Bangladesh with textiles and the Deepwater Horizon and whatever may come out of the Volkswagen scandal, are all things that we could learn from and use as the basis for improvements. All of those issues are useful in terms of raising the consciousness level that indeed businesses need to pay more attention to what their impacts are; beyond just how do they deliver on an earnings per share number, vis-a-vis their quarterly projections.”

While debates around ESG, risk disclosures and materiality will continue, one thing remains clear, “What got you here won’t get you there.” Protecting the status quo is not a sustainable business strategy.

Interviewees

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The following subject matter experts participated in in-depth research interviews and provided a variety of viewpoints regarding ESG risk disclosures.

- Anonymous, senior equity analyst, Institutional Investment Management Co.
- Dr. Bob Eccles, chairman, Arabesque Partners
- Carol Geremia, head of global institutional, MFS Investment Management
- Arnie Hanish, retired VP, chief accounting officer with Eli Lilly and board member at Omeros Corporation
- Eric Hespenheide, interim chief executive, GRI (formerly the Global Reporting Initiative)
- Rob Wilson, research analyst, MFS Investment Management

Credits

ABOUT THE AUTHOR

Thomas (Tom) Thompson is manager, Research, at Financial Executives Research Foundation (FERF), the nonprofit research affiliate of Financial Executives International (FEI). Thompson specializes in qualitative and quantitative research methodologies and has authored more than 60 executive reports and white papers. He earned a B.A. in economics from Rutgers University and a B.A. in psychology from Montclair State University. Prior to joining FERG, Thompson held positions in business operations and client relations at NCG Energy Solutions, AXA-Equitable and Morgan Stanley Dean Witter.

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