A shift in expectations

ESG – Enhanced reporting and the changing role of the board

2021

ESG – Why now?

ESG (Environmental, Social and Governance) is not a new concept. It extends far beyond environmental matters and impacts organisations across industries and geographies. Over the last two years however, it has become one of the most frequent topics raised by investors and other stakeholders to both executives and boards. Many companies that have focused on ESG in the past have done so somewhat haphazardly, and efforts to measure and report on activities haven't always been successfully integrated into strategy or disclosed.

If the last year has shown us anything, it's shown just how vulnerable organisations are to ESG risks such as employee health and safety stemming from COVID-19, social movements, climate change and workplace diversity. A PwC survey[1] found that only 38% of directors think ESG issues have a financial impact on an organisation. While ESG is 'on the radar' of many leaders, investors and other stakeholders are demanding stronger action and associated reporting from companies, with the threat of divestment or loss of access to financing very real. Equally, fast moving organisations are realising there are opportunities as well as risks in the ESG space.

This paper:

- provides an overview of the broad range of ESG issues that can impact a company
- highlights the forces driving renewed focus on reporting and the complexities of current frameworks
- addresses the role of the board, and poses questions directors should be asking themselves and their executive teams.

[1] PwC, Annual Corporate Director's Survey, 2020

"Doing good and doing well can and do co-exist. Threats like climate change or social disruption put shareholder capital at risk — investing in these areas addresses societal needs and fosters long term value creation and sustainability."

Bob Moritz, PwC Global Chairman

ESG - a significant opportunity

ESG encompasses an array of issues - some of which directors would be surprised to find fall under the ESG banner. In Australia, there has historically been a strong focus on issues that are part of the 'E' pillar. While these are not to be ignored, directors should be proactive in also considering the varying issues in the 'S' and 'G' areas. To the right are some topical current examples of items under particular ESG pillars.

While sector or region-specific ESG frameworks haven't yet been mandated by Australian governments or regulators, current available frameworks provide a guide for directors to consider. It's important to note that not all factors will be material to all companies.

Different stakeholders will have different objectives and needs. Prioritising and evaluating the risk profile and materiality of the various ESG topics is crucial for companies to proactively approach ESG and embed it into the organisation's strategy and purpose, with appropriate board oversight. It can also help to simplify what can otherwise seem an overwhelming set of possible issues.

Recent ESG reporting guidelines from the World Economic Forum's International Business Council and the Task Force on Climate-related Financial Disclosures (TCFD) take a step in the right direction. These guidelines mean companies will have to report more, not less. Regulators are also focusing on scale and quality of ESG disclosures and the link to potential impacts on financial statements. Companies will therefore need to have greater confidence in their data, processes and the controls which support this reporting.

All of this means that reporting must evolve. It should move from standardised boilerplate statements that simply 'comply', to companies considering how various ESG risks (material to them), provide a significant opportunity to differentiate and lead.

Environmental

- Water stress
- Waste management and the circular economy
- Biodiversity
- Response to climate change/net zero commitments

Social

- Responsible investment
- Supply chains including controversial sourcing/ modern slavery
- Community support during natural disasters and health crises
- Rights of First Nations Peoples including free, prior and informed consent (FPIC)

Governance

- Anti-competitive practices
- Board diversity
- Business ethics
- Corruption and instability

Stakeholder demands driving enhanced reporting

The growing wave of stakeholder (not just shareholder) focus in ESG, means companies who focus on the matter, will be positioning themselves ahead of their peers. Stakeholders want to know how companies are weighing ESG-related risks and shaping their business strategy accordingly. Investors and financiers in particular, are making capital and debt allocation decisions based on this information.

Investors

Investors believe that ESG is important in understanding a company's full risk profile. It's about the risks and opportunities which could impact a company's ability to create long-term sustainable value. It's therefore essential that companies are integrating forward-looking ESG considerations into their strategy, implementing relevant governance controls that will lead to long-term corporate resilience and better allocation of capital.

Other stakeholders

A company's customers, employees, communities, and suppliers look to management to drive value creation, while balancing broader organisational obligations it has to society. Their focus goes beyond the company's financial performance. This broad group play an important role in determining which ESG factors are deemed material for the company. Their priorities and concerns can guide (or sometimes force) management teams to focus on issues previously overlooked. In the medium to long term, the interests of investors and other stakeholders must be aligned for a company to be truly sustainable.

Reporting

In general, companies with articulated ESG strategies and risk and governance frameworks, will be able to present their value creation story more transparently. These detailed disclosures will better position companies to access capital and enhance their brand as more investors look to ESG practices as a litmus test for future investment.

Transparent disclosures in the form of qualitative disclosures and quantitative metrics (KPIs) are non-negotiable and will inform all stakeholders in their decision making. While companies are voluntarily disclosing ESG efforts in a number of places (including CSR reports, sustainability reports, company websites and other regulatory filings) investors are largely dissatisfied with the lack of standardised, quality disclosures available. Where disclosures aren't available from the company, stakeholders are using ESG data compiled or determined by third parties, such as rating agencies and media, to support their own independent analysis.

Some of the world's largest asset managers have voted against directors at companies that, in their view, lag on ESG. They say identification and management of the ESG issues material to a company are essential to resiliency and risk mitigation, as well as strategy execution. These investors are looking for more disclosures from companies so that they can better assess how the company is addressing ESG risks and opportunities.

Rating agencies

Raters, such as MSCI, Sustainalytics, S&P, and others, are increasingly using different types of ESG credit factors in appraising credit risk, for both companies and countries. They gather data about a company's ESG efforts through direct surveys or through the company's publicly available disclosures. They then provide ESG scores based on their view of a company's risk exposure versus industry peers. Qualitative and quantitative data inform these ratings which are then used to create ESG indices to help guide investors in making their decisions. The methodologies used by these agencies vary and the resulting ratings are not consistently aligned with a particular ESG disclosure framework or set of standards and may not meet the needs of all institutional investors.

Much of this third-party information is unverified. It may therefore be inaccurate, but without better corporate involvement, no one can be certain. By leaving a communications gap for third parties to fill, corporates are at risk of losing control over their ESG story.

Navigating the ESG reporting landscape

There are varying frameworks, principles and guidelines that exist which make the navigation of the ESG landscape difficult. The reporting landscape is however beginning to converge in terms of standards and disclosure frameworks to enable companies to disclose their material ESG information in a standardised manner. Below are some of the common standards and frameworks that exist.

Credible and trusted ESG disclosures are essential in providing stakeholders with the information they want. It allows them to have better insights into companies' ESG risks and their approaches to manage them. While standards offer specific guidance for measurement and disclosure, frameworks provide general guidelines on disclosure. Both the standards and frameworks will guide companies in obtaining assurance over disclosed information.

	SASB (Sustainability Accounting Standards Board)*	**GRI** (Global Reporting Initiative)	**IIRC** (International Integrated Reporting Council)*
About them	Is a US-based independent standard setting board that has developed globally applicable standards for 77 different industries across the three pillars of ESG.	The Global Reporting Initiative is an international independent standards organisation that helps businesses, governments and other organisations understand and communicate their impacts on issues such as climate change, human rights and corruption.	The IIRC is a global coalition of regulators, investors, companies, standard setters, the accounting profession, academia and NGOs. The coalition promotes communication about value creation, preservation and erosion as the next step in the evolution of corporate reporting.
Guidance	These standards provide guidance on how organisations can align their reporting with investor needs and how companies gather standardised data.	These standards address disclosures of socially material topics (climate change, human rights, governance etc) affecting a company's stakeholders. It requires companies to determine the issues that are material in consultation with stakeholders.	The International Integrated Reporting Framework is used to accelerate the adoption of integrated reporting across the world. It aims to improve quality of information available, promote a cohesive and efficient approach to corporate reporting, and enhance integrated thinking and accountability.
Framework / Standard	Voluntary standards (across 3 ESG pillars)	Voluntary standards (across 3 ESG pillars)	Voluntary framework (across 3 ESG pillars)

*December 2020 - SASB and IIRC announced plans to merge ("The Value Reporting Foundation"), as they work towards a comprehensive reporting framework being demanded by all stakeholders.

	WEF (World Economic Forum)	**TCFD** (The Task Force on Climate-related Financial Disclosures)	**IFRS** (International Financial Reporting Standards)**
About them	Is an international organisation for Public-Private Cooperation. It is independent and strives in all its efforts to demonstrate entrepreneurship in the global public interest while upholding the highest standards of governance.	Commissioned by the G20 Financial Stability Board to develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders.	An independent group of experts with an appropriate mix of recent practical experience in setting accounting standards, in preparing, auditing, or using financial reports, and in accounting education.
Guidance	A white paper titled 'Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation' released in January 2020. 21 core metrics (and 34 expanded metrics) were identified across 4 pillars aligned to the Sustainable Development Goals: Governance, Planet, People and Prosperity.	The recommendations of the TCFD help companies across industries understand what financial markets want from disclosures about how the company measures and responds to material climate change risks.	The principle based approach of IFRS Standards means that climate change and other emerging risks are addressed by existing requirements, even though such risks are not explicitly referenced.
Framework / Standard	Recommendations (across 3 ESG pillars)	Voluntary framework*** (Environmental pillar)	Standards (across 3 ESG pillars)

**February 2021, The IFRS Foundation reviewed responses to a consultation paper on sustainability reporting. The responses indicate growing and urgent demand to improve the global consistency and comparability in sustainability reporting, as well as strong recognition that urgent steps need to be taken and broad demand for the IFRS Foundation to play a role in this. The intention is for the trustees to produce a roadmap and timeline by September 2021 which could possibly lead to the establishment of a sustainability standards board.

***Jurisdictions including New Zealand and the United Kingdom are introducing mandatory TCFD disclosure requirements.

Qualitative and quantitative reporting

To ensure reports meet stakeholder needs they should include both qualitative and quantitative disclosures. Qualitative discussions will help companies reinforce their purpose in creating long-term sustainable value. In deciding which quantitative disclosures to include, management and the board will need to assess, taking into consideration the views of all stakeholders, which ESG topics are material to them and their industry.

In defining materiality, consideration should be given to both the:

- impact on the financial performance of the company, and
- impact of the company's actions on society, its brand and ability to create long-term sustainable value.

If a topic is determined to not be material, consideration should still be given as to whether this conclusion should be clearly communicated, to avoid stakeholders making incorrect assumptions.

As ESG reporting evolves and companies disclose more relating to these issues, the organisation's ESG metrics will come under increasing scrutiny. Making sure these metrics are prepared with the appropriate rigor for investor use and can hold up to regulatory scrutiny, will be crucial. To ensure continuous improvement, companies should assess their competitors' disclosures and third-party ratings to understand how they compare.

An ESG roadmap: from purpose to reporting

A company's purpose is its reason for existing. It embodies how it will achieve long-term ***sustainable*** value-creation. The key word being "sustainable" as the changing demands of all stakeholders require companies to ensure that they define their societal purpose to measure the success of their long-term value creation. Balancing these broad needs of different stakeholders requires management and the board to work together. Now more than ever stakeholders are wanting to see reliable, consistent and transparent disclosures that visualise companies' value creation journey.

> "The more your company can show its purpose in delivering value to its customers, its employees, and its communities, the better able you will be to compete and deliver long-term, durable profits for shareholders."
>
> Larry Fink
> Chairman and CEO, BlackRock

Defining your value creation - considerations for your ESG reporting roadmap

Identify all stakeholders

Consider the views and insights from all stakeholders. Be clear on what is most important to them.

Lead with Purpose

Define your purpose and set related goals that will help you create long-term sustainable value.

Cohesive Strategy

Develop a strategy that is linked to your purpose, integrates ESG and is embedded in the core operations.

Identify the relevant metrics that will be used to measure achievement of the strategy.

ESG topics

Identify ESG topics that are relevant and material to the company and industry in which it operates.

Governance and oversight

Assess how your data is gathered - are there internal controls and processes in place to enable consistent, accurate and timely reporting.

Ensure executive remuneration is aligned to ESG objectives.

Review policies in place to enable the board's timely and transparent oversight.

Regulatory

As part of governance and oversight, decide which ESG standards and reporting frameworks are feasible to meet and will therefore be adopted.

Re-evaluate

Regularly assess whether messaging and disclosures are consistent, transparent and resonate with all stakeholders.

Transparent reporting

Align reported metrics with those used by management in running the business.

Leverage standards or frameworks in defining metrics and trends.

Disclose comparative figures to demonstrate consistency and transparency.

Determine the appropriate format and how frequently to report.

Decide where to to disclose the information.

The role of the board - what has changed?

There are a number of areas in which the role of the board needs to be reviewed to take account of the increased ESG focus:

Purpose and strategy - In order to ensure appropriate governance is in place and to effectively oversee risk and the execution of the company's strategy, the board will need to understand how the material ESG topics are identified and managed. The way in which boards approach ESG risks and opportunities will have a significant impact on how management decisions and commitments are embedded in the overall strategy.

Underlying systems to support - Historically, the systems, processes and controls which support the production of non-financial information have been far less robust than those underlying financial reporting. With ESG reporting receiving increasing attention, boards will have a strong role to play in ensuring there is appropriate control and governance over the quality of the information produced.

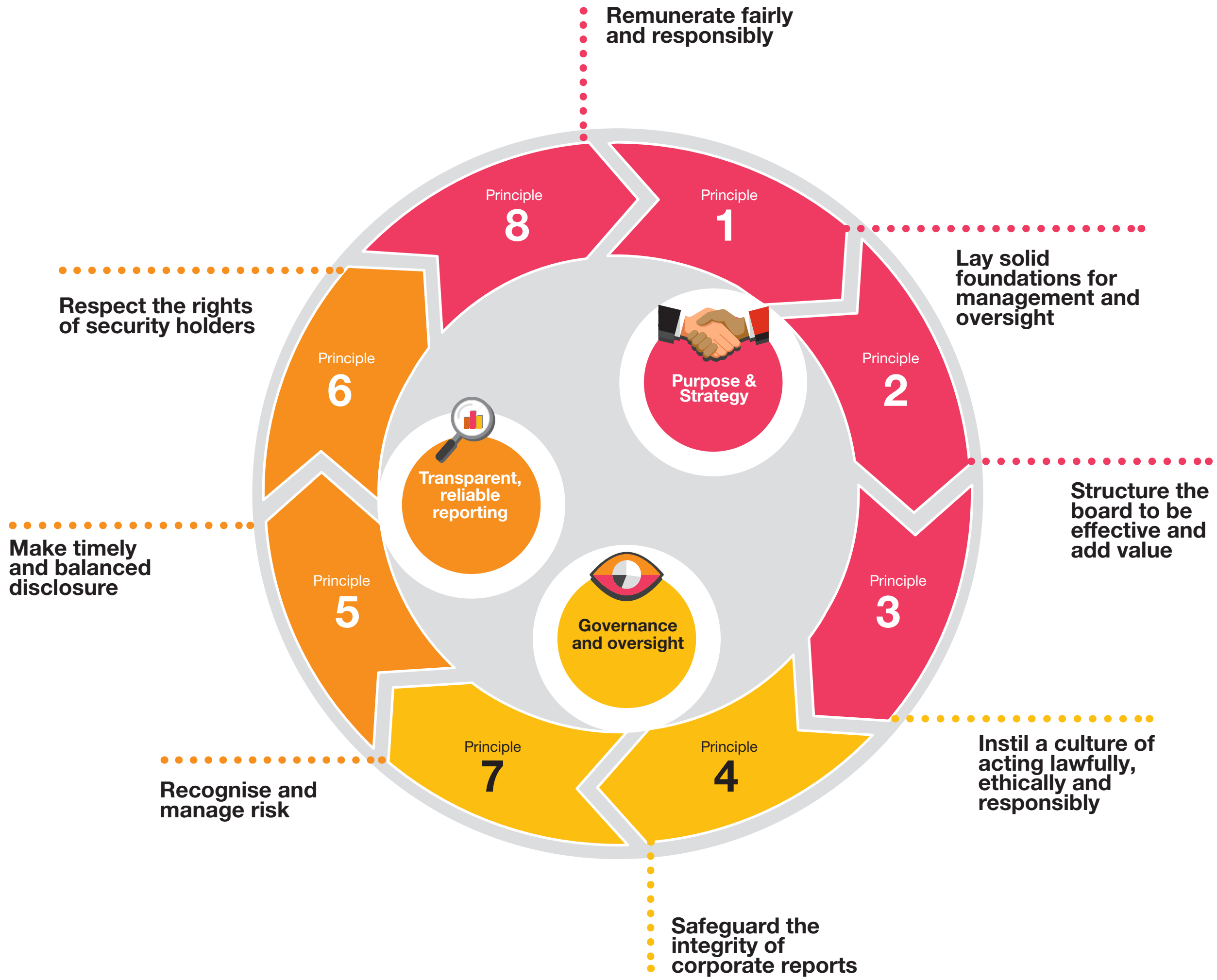
Reporting - As stakeholders and regulators focus on the extent and quality of corporate ESG disclosures, the governance process over external reporting of non-financial reporting should be reviewed.

ASX Corporate Governance Principles and Recommendations

The fourth edition of the ASX Corporate Governance Principles and Recommendations is applicable for all financial years commencing on or after 1 January 2020. It addresses emerging issues around culture, values and trust as stakeholders' (not just shareholders') expectations are changing the game on corporate reporting.

The diagram highlights how the principles can be mapped back to the ESG areas of focus above.

Considerations for the board when applying The Principles and Recommendations:



Considerations for boards

Purpose and strategy

- Has management considered and balanced the views and needs of all stakeholders as part of the identification of material ESG topics?
- Is the company's purpose and the role that it plays in society defined?
- Is the ESG strategy embedded into or aligned with the company's overall strategy?
- Is the board satisfied that the entity's remuneration policies are aligned with the entity's purpose, values, strategic objectives and risk appetite?
- Does the board have the necessary skills and knowledge to discharge its duties effectively for ESG related matters?

Governance and oversight

- Does the enterprise risk management process include assessment and mitigation plans for all material ESG-related risks that have been identified?
- Has management prioritised material ESG risks and opportunities? Have these been included in capital allocation decisions?
- Is the board overseeing ESG goal setting and identifying the relevant metrics to measure, manage and communicate progress?
- Is the board satisfied the right systems, processes and controls are in place to ensure consistency, completeness and accuracy of reporting?
- Has the company considered obtaining assurance over ESG disclosures?

Transparent, reliable reporting

- Which ESG standards and frameworks have been evaluated to determine whether the company is addressing the most significant risks and issues facing its industry?
- Does ESG messaging align and convey the commitment to creating long-term sustainable value?
- Is the ESG report standalone or integrated? Where is it located, and how frequently is it updated?
- Is the company transparently communicating both qualitative and quantitative appropriate information (balanced reporting) to inform all stakeholders?
- Is the board satisfied that timely disclosures can be made?
- Is management monitoring what competitors and rating agencies are reporting?

Many investors are focused on the connection between ESG goals and executive compensation. By tying incentive plan metrics explicitly to the company's ESG strategy, a company is not only encouraging the achievement of those ESG goals, it is also signalling the importance of those issues. A large number of companies have already taken steps to link incentive metrics to the ESG strategy.

Assigning ESG responsibilities within the board

ESG issues are relevant to all directors, regardless of the specific board they sit on. And, as the governance surrounding ESG becomes a greater focus, directors will need to consider how (or should) they assign specific oversight for particular ESG issues to individual committees.

Full board

As the board determines where ESG oversight will be assigned, it may want to consider the following questions:

- Do we have a specific committee with the capacity, interest, and skills to take the lead on overseeing the company's overall ESG efforts? If not, will the full board take on this responsibility or should we create a new committee?
- Have we considered how the committees will stay aligned on ESG considerations? Have committee charters been updated to transparently disclose to shareholders and other stakeholders the board's allocation of ESG oversight responsibility?

Audit committee

- **Reporting and disclosures:** Are the ESG disclosures (both qualitative and quantitative) investor grade? Which ESG frameworks and/or standards is the company using?
- **Processes and internal controls:** Are there processes and Internal controls in place to ensure ESG disclosures are accurate, comparable, and consistent?
- **Assurance:** Should independent assurance be obtained to provide additional comfort to stakeholders that ESG disclosures are reliable?

Compensation committee

- **Accountability**: Are the ESG goals and milestones effectively integrated into executive compensation plans?
- **Talent and culture:** How is management organised to execute the ESG strategy? Are the right people and processes in place? Does the company have a culture which embraces ESG efforts?

Nomination and governance committee

- **Board composition:** Does the board have the necessary expertise and skills to oversee ESG risks and opportunities?
- **Education:** Does the board understand why ESG is important to investors and other stakeholders? Is the board appropriately educated on ESG?
- **Shareholder engagement:** Is the company's ESG story being effectively communicated to investors and other stakeholders?

How PwC can help

To understand how your organisation meets industry and territorial expectations and compares to peers, please reach out to your PwC contact, or connect with one of our subject matter experts below.

John Tomac
Sustainability & Risk

john.tomac@pwc.com

John O'Donoghue
ESG Reporting

john.odonoghue@pwc.com

Rosalie Wilkie
Social Impact

rosalie.wilkie@pwc.com

Adam Cunningham
Sustainability & ESG Reporting Director

adam.cunningham@pwc.com

pwc