The future of ESG and corporate reporting

The developed world has finally woken up to the importance of ESG reporting. **Stephen Butler** explains why, and what still needs to be done if companies are to truly embrace the new culture.

Environmental, social and governance (ESG) factors have emerged as a dominant framework for assessing the long-term sustainability of an organisation. As stated in *The Economist* in December 2019, at least $3tn of institutional assets track ESG scores, and the percentage of assets under management that are screened using ESG criteria is increasing all the time. And according to State Street Global Advisors, a leading ESG-focused fund manager (founded in the US around 40 years ago), ESG criteria are now a component of investment strategies for four fifths of global institutional investors. Not surprisingly, ESG scores are becoming ever more important. Therefore, organisations need to have a coherent narrative to describe their ESG strategies.

There is a growing realisation by investors that the negative impacts on the environment and society of an organisation's activities may outweigh the benefits of the goods and services that it provides. According to the University of Oxford's Saïd Business School, the management of public companies and the investment priorities for asset managers have become 'a first order question in corporate governance across the developed world.' In other words, ESG is going mainstream.

This is not surprising given the existential threat of climate change that hangs over society and commerce. The world's preparation for the inevitable impacts of the climate crisis are 'gravely insufficient', according to a report by the Global Commission on Adaptation published in 2019. Government negotiators from around the world met in Madrid in December 2019 at the 25th annual UN Climate Conference of the Parties (COP25), and strained many sinews trying to foster international collaboration to address climate change and to progress carbon reduction strategies struck in Paris in 2015. But progress remains slow.

Here at Luminous, we published our 20 top trends for 2020 in January this year, with a subset of these being sustainability related. In addition to climate change, the other key issues we identified were responsible supply chain management, making progress towards the UN Sustainable Development Goals, and pressure (potentially moving from fatigue to paralysis) placed upon preparers of ESG disclosures – all of which have been brought into sharp focus.

What investors are looking for has evolved

It's no surprise, then, to learn that institutional investors have an increasingly diverse range of material topics across the ESG spectrum about which they are interested in engaging with companies. But key subject areas differ widely between investors, which makes it challenging for some corporates to respond with a good narrative.

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GOING MAINSTREAM

- **Companies world-wide are realising the significance of their environmental and societal impact.**
- **Some companies are still in 'box ticking' mode – without fully embracing the principles of ESG.**
- **Full presentation of risks, both financial and non-financial, enables fund managers to make better and faster decisions.**

An upswing in the prioritisation of climate change and carbon reduction activity has been universal, but it is not the only game in town. Equality, diversity and inclusivity issues cut across an entire organisation's population, and this is another area that is coming under greater scrutiny by asset owners and fund managers.

However, an ESG-focused conference co-organised by the University of Oxford's Saïd Business School in 2019 highlighted that asset owners are sometimes 'missing in action' insofar as they do not engage, or have time to engage, in their investments. If you are a portfolio manager with hundreds of listed companies in your fund to manage, there is no simple or time-efficient way to properly engage on ESG issues. Passive engagement when it comes to fund management is increasingly insufficient.

Just because your investment fund has voted down a shareholder resolution or two does not count as 'engagement'. Engagement has to incorporate action, activity and dialogue – meeting key stakeholders within a business and asking the challenging questions, for example. At present, there appears to be little collaboration within the investment industry to simplify interrogating corporates. The diversity of approaches they receive simply induces 'questionnaire fatigue' among investor relations and sustainability teams.

This article was published in the Spring 2020 issue of *Informed*, the quarterly members' magazine of The Investor Relations Society, as part of a special feature titled 'ESG going mainstream'.

How corporate reporting should communicate ESG issues

In many senses, UK reports have for some time been required to report in relation to ESG and other matters through the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, and the EU Non-Financial Reporting Directive.

However, many companies tick the box while missing the point. At Luminous, our sustainable business team works with both listed and private companies to define and communicate their ESG story.

Here are our top four recommendations for defining and communicating your ESG story:

1. Engage your investors – understand how your investors are integrating ESG information into investment decisions and models.
2. Identify what's material – conducting a materiality review is a useful method to understand what matters most to your stakeholders, along with the associated risks and opportunities. As part of this process, take into consideration relevant frameworks such as the Global Reporting Initiative's (GRI) G4 guidelines, the Sustainability Accounting Standards Board's (SASB) standards, the Task Force on Climate-related Financial Disclosures (TCFD), and the United Nations' Sustainable Development Goals (SDGs).
3. Integrate, don't silo – weave ESG information through the report and other investor-focused communication to demonstrate how it impacts operations and the long-term sustainability of the business.
4. Develop specific targets – It's important to develop metrics and targets that are relevant to your company's materiality and sector. Consider providing independent assurance of reporting and non-financial data.

What's next?

The integration of ESG thinking has gone mainstream within the investment sector – returns will be better, and the volatility of such investments will be less. Corporate governance (the 'G' in ESG) sits at the intersection of law, politics and finance, and in due course markets and stock exchanges will determine the required set of disclosures that are acceptable without overburdening organisations.

> ' The investment industry has a good track record of pushing the agenda for better disclosure and transparency, which is enlightened self-interest in many respects '

However, with this in mind, there is still plenty of room for improvement in ESG disclosures prepared by organisations. According to *The Economist*, the scoring systems are not always measuring the right things, and data can be out of date and incomplete. Furthermore, according to its research, *The Economist* found that only half of the c.1,700 companies in the Morgan Stanley Capital International (MSCI) World Index reveal their carbon emissions, which seems a basic requirement.

Mark Zinkula, the recently retired CEO at Legal & General Investment Management has previously stated that "ESG reporting is not just for larger companies. This is about all issuers, regardless of size, reporting relevant and material information to investors so that they can make better informed investment decisions."

The investment industry has a good track record of pushing the agenda for better disclosure and transparency, which is enlightened self-interest in many respects. It is much easier for an analyst to produce a buy, sell or hold recommendation if there is a clear understanding of the non-financial risks, as well as the financial risks, of an existing or potential investment opportunity.

Two-way dialogue, transparency and robust disclosures remain as important as ever. ■

Luminous will be publishing an ESG-focused special edition of its thought-leadership publication, Reporting Matters, later this year.

If you would like to receive a copy, please get in touch with Stephen Butler.

Keep up to speed with the latest ESG issues and how they affect the IR community. From *Informed* to webinars, events, white papers, courses and more, the IR Society has a wide range of resources to assist you. Find out more: www.irsociety.org.uk