World Environment Center

ESG Disclosure: Navigating the Complexity of New Financial Requirements in the U.S. and Europe

Executive Roundtable Summary (Washington, D.C. –March 15-16, 2023)

Background

Information about a company's sustainability performance has become an increasingly important part of financial analysis. As investors and value chain partners ask for transparency of environmental, social and governance (ESG) data, they aim both to reduce risk in their portfolio and to identify growth potential. In parallel, government regulation is now more ambitious than ever. Both are merging financial with sustainability reporting and thus are driving ESG disclosure obligations and frameworks in the U.S., Europe, and other markets. This development has been accelerated by digitization and the appearance of unparalleled technology, enabling organizations to evaluate and compare large amounts of data and to feed them into multiple disclosure frameworks.

This WEC Executive Roundtable, co-sponsored by Beveridge & Diamond and ERM, brought together 32 senior sustainability and financial disclosure experts from the U.S., Germany and the UK – with 94% from large companies of various industries and 6% from Think Tanks and NGOs.

Participants

Co-Sponsors:

- **Lauren Hopkins**, Principal, **Beveridge & Diamond**
- **Jennifer Klie,** Partner, Corporate Sustainability, **ERM**

Moderators

- **Beveridge & Diamond**: Lauren Hopkins
- **ERM:** Jennifer Klie
- **ESG Book:** Maria Mähl
- **Ksapa:** Julie C. Muraco
- **World Environment Center:** Glenn Prickett

Speakers

- **BASF:** Tanja Castor
- **Beveridge & Diamond**: Lauren Hopkins
- **Boston Consulting Group:** Tim Mohin
- **Chemours:** Dorothy Brandt
- **Constellation:** Laura Ballard
- **Diageo:** Jayant Kairam
- **FedEx:** Heather Valentino
- **Jacobs:** Terri Herson
- **Ksapa:** Julie C. Muraco
- **Ricoh**: Kousuke Ito

Key Points

1. **The merging of Financial and ESG Disclosure is real, it is demanded by investors, it requires time for preparation, and it is not going to change.** Currently 96% of global companies are disclosing ESG under a model that aims at double materiality, meaning that their Sustainability Reports address stakeholders such as consumers, NGOs, and employees as well as shareholders. The dynamism around ESG arises from single materiality—the concept that some ESG data is material to investors. The Sustainability Accounting Standards Board (SASB) and International Sustainability Standards Board (ISSB) encapsulate financial materiality. A very important recent development is the consolidation of these two standards, along with the International Integrated Reporting Framework, through the merger of Value Reporting Foundation (which maintained SASB and IIRF) into the IFRS Foundation (which maintains ISSB).

   Government rulemaking for mandatory disclosure is underway in the EU, U.S., and UK. One important difference in the EU regulation is that double materiality will still form its basis even though investors are addressed as a major group. EU-based companies will be required to report under this framework starting January 2024. ESG and financial disclosure timelines will have to align. For the former, reporting now also needs to incorporate audits and assurance, as well as sign-offs from the CFO and General Counsel, due to risk of penalties for misreporting. For those who are not sure how to start this challenging process to disclose data before it can be validated, participants referred to the experience in financial reporting:

there, too, it happens all the time that some figures (e.g. laid out in utility bills) can only be estimated and then, in a second review, are confirmed with validated data. The advice is to first look at business processes and then plug in the key responsible individuals within the company who can be involved. As for the topics, start with climate. Everything else follows.

2. **The SEC Climate Rule, issued in draft form and awaiting final rulemaking, is financial disclosure focused only on climate.** However, given that several years ago the SEC created disclosure obligations with regard to conflict minerals, it is likely that after the Climate Rule, SEC may undertake rulemaking on other ESG topics, such as diversity, human capital, human rights, and biodiversity disclosure. The draft Climate Rule covers Scopes 1, 2 and 3. Given the difficulty of collecting reliable data on Scope 3 emissions, it is unclear how they will be addressed in the final rule. The final rule is likely to face litigation challenges. Also, based on the conflict mineral case, in which the SEC voluntarily paused parts of the rule requirements, it is conjectured that certain reporting obligations may move forward while the SEC might voluntarily put others on hold. In any event, companies should prepare for the possibility of an extended period of regulatory uncertainty.

3. **The European Union's vehicle for mandatory ESG-reporting is the Corporate Sustainability Reporting Directive (CSRD), which is an element of the Green Deal. Sustainability reporting is gradually elevated to the same level as financial reporting.** Other key instruments for corporate disclosure under the Green Deal are the European Sustainability Reporting Standards (ESRS), the EU Taxonomy, and the Sustainable Finance Reporting Directive (SFDR), as well as the Corporate Sustainability Due Diligence Directive (CSDDD). The SFDR is applicable to financial market participants only while the CSDDD, aiming at mandatory human rights and environmental due diligence, is not yet adopted. CSRD becomes mandatory for all large European companies (e.g. >250 employees and >40 Mil € turnover) for FY2024 reporting in 2025. For subsidiaries of international companies, it becomes mandatory for FY2025 reporting in 2026; for non-EU companies with significant business in the EU, CSRD becomes mandatory at group level for the FY2028 reporting cycle in 2029.

   While the CSRD structure is aligned to mirror the TCFD/ISSB approach (and thus: *financial materiality*) it has also incorporated the GRI standards (and thus: *impact materiality*). Reasonable assurance is demanded from the beginning for climate related information; for each of the 12 sector-agnostic standards (ESRS) reasonable assurance is required for the FY2028 reporting cycle onwards. It was recommended that U.S. based companies with EU subsidiaries review Article 19a for their reporting cycle of FY2025 (in 2026).

4. **Navigating between the two major evolving disclosure standards, CSRD and ISSB,** requires an understanding of how these standards originated. CSRD was legislated by the EU for the European jurisdiction, with European norms and aligned with international financial disclosure standards. ISSB is a global, non-governmental standard and sits alongside the international accounting standards (IASB) under one roof (the IFRS Foundation). Only as a second step will ISSB be customized for specific national jurisdictions. The first final ISSB standards are expected to be publicized during Q2/2023 and then individual jurisdictions will determine if application of the ISSB standards is required or permitted as a basis for mandatory sustainability reporting.

   An even more important difference -- and perhaps the major point of distinction for global companies who evaluate what fits their purpose – is the double-materiality approach of CSRD vs. single materiality of ISSB (see above). Are you addressing civil society, employees, consumers, governments along with investors? Then CSRD already covers them all. If investors are clearly your most important audience, ISSB focuses even more on that group (although some convergence with GRI is likely). Some companies try to cohere their core business plan and ISSB reporting with the UN SDGs and address stakeholder expectations beyond investors that way. Roundtable participants argued that these developments have in common that they can make the longstanding GRI-reports superfluous, especially in the EU, when a CSRD report contains the required information anyway. Finally, assurance: both CSRD and ISSB are expected to follow what is called "reasonable" (meaning substantive) assurance although the exact how is not completely clear, especially at ISSB.

It has also been argued that a "wait-and-see approach" does not work. Too many requirements must be met under both standards, too much preparation is necessary, too many levels of assurance are required. Therefore, companies are advised to start the process immediately. The good thing is that both CSRD and ISSB require a very similar way of structuring the information into (a) Governance, (b) Strategy, (c) Risk Management, (d) Metrics and Targets. Those with operations in Europe have no choice but to report according to CSRD. Whether they also want to disclose according to ISSB must be determined according to the specific value for the company's interaction with investors beyond the EU.

Companies with no significant business in Europe, who want to limit potential liabilities in reporting may still strive for a single, consolidated report according to ISSB, but restrict disclosure to topics that meet the materiality definition. If they want to communicate to stakeholders beyond investors, they may refer to other platforms (e.g., sales presentations, sales sheets, social media), to provide ESG information that speaks to a broader audience.

5. **Tools and technology to keep up with disclosure obligations are urgently needed.** Right now, there is no tool* for everything, and "everything" may be defined differently every year. Technology tools should at least consider measurement and reporting for multiple assets. The vast number of frameworks, rating agencies, customers, specialized stakeholders who all demand ESG-disclosure has led to a do-it-yourself hybridization of systems—companies are building their own internal tools to structure the information and pass it on. Among the challenges are (a) high levels of complexity paired with short time horizons/ disclosure deadlines; (b) amassing data from multiple sources before inputting them into the tool is cumbersome, particularly as the data collection process may not coincide with billing cycles. How do you then resolve estimations and real data? (c) some data is confidential and the data owner, e.g. HR, doesn't want to disclose it in the main software tool that would be used to answer disclosure requests from stakeholders that they don't know well; (d) information gathering at the entity level has to reflect local corporate, cultural, and social definitions and languages (one company added a dimension in a software tool on the market that specifies terminology and methodology); (e) investment in local HR controllers is needed to collect context specific social data.

   Company experiences with evaluating software tools show that many of them have similar solutions at the back-end, e.g. similar visualizations. However, the real challenge for companies is gathering the data at the front end, e.g. how the data is going to move through an approval process within the company? Definitions, language, regulation barriers, and verification of the accuracy of data are only the most important aspects. Despite the challenges, roundtable participants expect that tools will become of greater help each year. They also expect that tools will get more sophisticated once the final versions of the SEC Climate Rule, CSRD, and ISSB are available.

6. **With ESG moving to the Center of Strategy and Risk Management, ESG disclosure will be managed from various parts in the company.** Any kind of corporate disclosure brings liability. As one participant put it: "The ESG controller is now the most important position you never thought you'd need." The finance team generally focuses on numbers and cutting costs, while the sustainability team puts these numbers into context. This is an opportunity to break down silos because legal and financial departments – who do not

know as much about ESG – now feel a need to involve the sustainability team, who can evaluate the full context when it comes to compliance and certification of ESG-related information. It starts with limited assurance and the bar rises while all information must be properly documented. Even for the leading companies in the room it was a huge stretch to reach reasonable assurance levels for CO2-emissions that a CFO would be willing to sign. Knowing that the CSRD requires reporting on ~1,000 data points for some industries at this quality level (laid out on 350 pages for 12 standards) makes clear companies will need the entire capacity of their controlling community and cannot work in silos. Over the years, the sustainability teams have learned to work with many departments in the company, sometimes diverging interests, so they can now draw from their empathy and change management skills.

Supervisory boards will also have to be engaged because they are liable for misreporting, and because the board's expertise on climate and other topics must be disclosed. Discussions made clear that now is the time for every company to set up the right structures, processes, and education to have a board committee or subcommittee for ESG disclosure in place once it is needed.

Finally, to summarize the real achievement from the SEC Rule, CSRD and ISSB frameworks one participant put it this way: "by organizing disclosure requirements, they are looking at the tail end while what they are really demanding is an upstream transformation that takes place at the core strategy and business model of corporations". With that in mind, the terms "ESG" or "Sustainability Reporting" may not do the disclosure justice. Participants suggested that a better term may be Integrated Report, Impact Report or Business Report.

Tools that were mentioned are Crunchbase, Workiva and xOverTime out of what was estimated approximately 80 software tools currently on the market.

Note: WEC Executive Roundtables are conducted under the Chatham House Rule. WEC would like to thank Shruti R. Samala at BEVERIDGE & DIAMOND for notetaking and preparing the first draft of this summary.