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Marketing
Strategy

ESG Reporting Beyond 2022: Understanding Upcoming Changes

In late 2022, changes were on the horizon in the world of Environmental, Social, and Governance (ESG) reporting. In Europe, mandatory ESG reporting rules were only a few months off for large firms. The accounting profession, through the International Financial Reporting Standards (IFRS) Foundation, was preparing Sustainability Disclosure Standards. And the US Securities and Exchange Commission (SEC) was asking for public comments on climate disclosures.

Background to ESG Reporting

The 1992 Earth Summit in Rio led to the UN Framework Convention on Climate Change (UNFCCC). An annual follow-up, the Conference of the Parties (COP) to the framework, was instigated in 1995[i]. The 27th conference, COP 27, occurred in 2022. These meetings are attended by many heads of government and seek to focus the world on reducing greenhouse gas (GHG) emissions and limiting the impacts of climate change.

The 1997 Kyoto Protocol set limits on six major greenhouse gas emissions for developed countries. Despite being signed by President Clinton, this was never ratified by the US congress[ii]. The 2015 Paris Agreement was a legally binding treaty to limit global warming to 2 degrees, with 1.5 being a preferable limit[iii]. The US left this agreement in 2020 under President Trump before rejoining in 2021 under President Biden[iv].

GHG emissions are not the only ESG problem. For example, environmental challenges included plastic pollution and biodiversity loss. Social challenges include promoting diversity and equity and stopping forced labor. Governance challenges include setting ethical standards and stakeholder engagement.

Financial and Non-Financial Reporting

External reporting arose, at least somewhat, as a way to ensure an organization's shareholders and creditors that managers of the firm aren't stealing money. Thus, financial accounting, the discipline specializing in external reporting, has focused on financial reports: e.g., the balance sheet, income statement, and cash flow statement. Accompanying notes to the accounts provide more detail. Information shared in these statements is covered by various rules, known in the US as GAAP (generally accepted accounting principles). Auditors check that the statements are correct—in other words, there are no "material" errors.

Managers can publish non-GAAP (discretionary) reports that share financial and operational information that shareholders might want to know and are not covered by traditional reporting. Such reports can be useful, but they come with limited assurance and can also be misleading. Managers also disclose additional information in commentary. This can be non-financial and unstructured (e.g., text based). Disclosures must be truthful, but without a standard format it is hard to compare disclosures across companies and time.

ESG reporting is a relatively recent development. ESG reporting seeks to show how companies and other entities are performing on major issues related to the environment, society, and corporate governance that do not fit in the standard external financial reports. It is now common for major firms to report on ESG. For example, Coca Cola issues an annual ESG report[v]. The Governance and Accountability Institute states that "92% of the S&P 500® and 70% of the Russell 1000® published sustainability reports in 2020."[vi]

Greenwashing

Sharing ESG performance on a voluntary basis ultimately results in many different approaches. Unfortunately, this lack of standardization can lead to confusion and skepticism. Some observers even argue that firms are greenwashing, making inappropriate or misleading environmental claims.

"Greenwashing is the process of conveying a false impression or misleading information about how a company's products are environmentally sound."[vii]

Some forms of greenwashing are a matter of perception. A firm with an unsustainable portfolio might take steps toward improvement and highlight those positive steps, but not disclose or highlight the remaining problems. Some observers may then celebrate the positive gains or aspirations expressed, while others focus on the problems.

Furthermore, decision-making in organizations is complex. If part of a firm sincerely pursues a path to sustainability, does lack of achievement in another part invalidate the positive efforts? Tradeoffs are a common practical challenge of pursuing sustainability. For example, is good performance on the environment enough to give the firm a pass on social concerns?

Practices typically associated with allegations of greenwashing include misleading (or unsubstantiated) claims and sins of omission (not mentioning the company's bad practices while touting the good).

Examples of Potential Greenwashing

Ryanair, a low-cost Irish airline, was accused of greenwashing after its claim "Europe's lowest fares, lowest emissions airline" was banned by the UK's advertising watchdog. The emissions data used was dated and omitted key competitors. The watchdog also said Ryanair should have factored in passenger density. Ryanair's policy of packing in passengers meant more people on each plane and so fewer emissions per passenger[viii].

Coca Cola's sponsorship of COP27 was controversial due to its use of plastics. Despite its recycling plans, critics noted that it spent vastly more on advertising than on dealing with its pollution[ix].

H&M, the fashion retailer, faced lawsuits over its Conscious Choice clothing collection. It had produced environmental scorecards for these products but a report suggested that more than half the scorecards showed better environmental performance than justified while some claims were simply untrue. Experts have suggested that firms

should treat their non-financial reporting as seriously as their financial reporting and that trade associations are not credible as the arbiters of claims[x].

Volkswagen (VW) promoted its diesel cars as being “Clean Diesel,” an alternative to electrification in improving transport emissions. Yet, VW had installed software to cheat the emissions tests by US regulators such as the EPA (Environmental Protection Agency). These “defeat devices” recognized when a test was occurring and altered performance to dramatically reduce emissions to less than the federal limits. In normal driving mode, to gain more mileage and power, the diesel cars emitted up to 40 times the permitted limit of nitrogen-oxides (NOx)[xi]. In 2014 the International Council on Clean Transportation and the Center for Alternative Fuels, Engines, and Emissions (CAFEE) at West Virginia University noticed that VW emissions differed outside the EPA tests[xii]. Recalls, charges, and lawsuits followed, costing VW more than $35 billion[xiii]. Oliver Schmidt, VW’s liaison to the US government, was sentenced to seven years in jail[xiv]. Martin Winterkorn, the VW CEO at the time who also chaired the Audi and Porsche boards, became a fugitive from US justice. He was wanted for conspiracies to defraud the US, violate the Clean Air Act, and wire fraud[xv]. He also faced charges in his native Germany[xvi].

The Development of ESG Reporting

There has certainly been a need for guidance on ESG issues. The Principles for Responsible Investment (PRI), developed in 2005 and published in 2006 at the request of the UN Secretary-General, aim to aid investors in making decisions that uphold high ESG standards. The six principles can be endorsed by investors and emphasize the importance of ESG reporting[xvii]. The PRI are supported by the UNEP FI (United Nations Environment Programme Finance Initiative[xviii]).

Indeed, interest in investing in responsible companies has grown dramatically. In 2011 there were 890 signatories to the PRI representing $24 trillion in assets. By 2021 this had risen to 3,826 signatories representing $121.3 trillion in assets[xix]. Support for ESG-related shareholder resolutions—instructions (often non-binding) sent by owners to managers—was also high[xx].

Unfortunately, there has been significant confusion about ESG measurement: what was being measured and how measures related to each other. The MIT Sloan Sustainability Initiative has suggested that ESG ratings correlate with each other at only 0.54[xxi]. In essence, the various ESG ratings often measure different things and/or have a lot of noise (imperfections).

ESG reporting's problems have not from lack of attention. (Table 1 shows relevant acronyms commonly used in the ESG field). The GRI (Global Reporting Initiative), founded in 1997, developed the "most comprehensive set of sustainability reporting standards,"[xxii] including general and sector-specific standards. The CDP (Carbon Disclosure Project), founded in 2000, provided a system to help investors, companies, and governments manage their environmental impact.

Table 1. Key Acronyms in ESG Reporting

CDP	Carbon Disclosure Project		IASB	International Accounting Standards Board
COP	Conference of the Parties to the United Nations Framework Convention on Climate Change		IFRS	International Financial Reporting Standards
CSRD	Corporate Sustainability Reporting Directive		ISSB	International Sustainability Standards Board
EFRAG	European Financial Reporting Advisory Group		NFRD	Non-Financial Reporting Directive (replaced by CSRD)
EPA	Environmental Protection Agency		PRI	Principles for Responsible Investment
ESG	Environmental, Social, and Governance		SEC	Securities and Exchange Commission
ESRS	EU Sustainability Reporting Standards		SASB	Sustainability Accounting Standards Board
FASB	Financial Accounting Standards Board		TCFD	Taskforce on Climate-related Financial Disclosures
GHG	Greenhouse gas		UNEP FI	United Nations Environment Programme, Finance Initiative
GRI	Global Reporting Initiative			

Accountants, who handle most of the corporate reporting operations, have embraced ESG reporting. SASB (Sustainability Accounting Standards Board), founded in 2011, developed detailed reporting standards. SASB provides sector-specific standards that

seek to connect reporting on a firm's past performance on sustainability-related issues with investors considering the financial impact of that performance[xxiii].

SASB joined the International Integrated Reporting Council to form the Value Reporting Foundation (VRF)[xxiv]. The VRF did not last long, as it soon joined the Climate Disclosure Standards Board and the newly formed International Sustainability Standards Board (ISSB). The ISSB name continued and the new organization operated under the IFRS Foundation (International Financial Reporting Standards)[xxv]. The IFRS Foundation also oversees the IASB, the International Accounting Standards Board. This sets non-US financial reporting standards.

"The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions." ISSB[xxvi]

As of 2022, the IFRS was still recommending the SASB standards and these had seen significant uptake. There were 117 firms using SASB reporting standards in 2019. By November 2022 this had increased to 1,816[xxvii].

Materiality and Double Materiality

Company reporting traditionally employs the concept of materiality—i.e., the "significance" to the financial performance of the reporting entity. Something is seen as financially material if reasonable people might see the factor as important to understanding the firm's financial performance.

From a materiality perspective, risks from ESG-related factors matter to the reporting entity. For example, a property developer might report the financial risk from climate change to a portfolio that could be negatively affected by rising sea levels. A consumer packaged goods firm might recognize financial risk from regulations that limit plastic pollution. A quick-service restaurant might see financial risk from the need to improve employee benefits. Concern for risks, whether or not they relate to ESG factors, is

Investment 101. Even the most traditional investors really should consider material ESG financial risks.

A less financially focused idea is double materiality. The double materiality approach sees materiality as related to more than just the investor's finances. Double materiality expands upon what is seen as important to include harm caused by the firm's impact on climate change and the environment, e.g., material impact beyond just the financial.

> *[In the field of climate change] "While materiality is the effect of climate change on finance and corporate activities, double materiality includes the effect of finance and corporate activities on climate change."*[xxviii]

This parallels with a shareholder versus stakeholder view of the firm. A shareholder focused view of the firm will see ESG risks as important because they impact the owner's investment. Double materiality sees ESG risks as important, not only because they could harm investors, but also because of the impact these risks have on other stakeholders.

The European Union's Non-Financial Reporting Directive requires double materiality assessment when companies are conducting ESG reporting. In addition, if a company were to decide that climate change is not a material issue, they must submit additional justification[xxix].

Scope 1, 2 and 3 Emissions

A challenge with reporting is measuring the precise damage that companies create. In the case of climate change, one important measure is greenhouse gas (GHG) emissions. The category of emissions that a firm directly generates is called Scope 1 emissions. These are relatively easy to measure. Scope 2, indirect emissions from purchased energy, are associated with the firm's energy use (e.g., emissions from generating the power for the company's factory). This is usually relatively easy to track too.

The biggest reporting challenge comes from Scope 3 emissions, indirect value chain emissions. These are the emissions generated to provide the firm's products but not directly created by the firm. Suppliers are a common source of these emissions. While

these can be extremely hard to track, it is vital to do so. Otherwise, a firm could outsource GHG-emitting functions to third parties, making the firm look better but not helping the environment, since emissions would not change.

Beyond preventing deceptive restructuring, tracking Scope 3 emissions encourages firms to work with their partners, such as suppliers, to reduce emissions. Consumer facing firms, those most likely to face consumer pressure, who report Scope 3 emissions are incentivized to encourage environmental stewardship from partners who are more insulated from consumer response.

Europe and ESG Reporting

Governments have also been getting involved. In 2022, the UK government made climate-related financial reporting mandatory for large firms[xxx]. This focused on investment financial risks from climate in line with advice from the Taskforce on Climate-related Financial Disclosures (TCFD). This taskforce, chaired by former New York mayor Michael Bloomberg, gives advice on how firms could better inform "investors, lenders, and insurance underwriters in appropriately assessing and pricing a specific set of risks—risks related to climate change."[xxxi]

The EU has for a number of years required reporting of non-financial information by certain large companies[xxxii]. These requirements cover:

- Environmental matters,
- Social matters and treatment of employees,
- Respect for human rights,
- Anti-corruption and bribery,
- Diversity on company boards (age, gender, educational and professions).

The EU's Non-Financial Reporting Directive (NFRD) was not seen as sufficiently comprehensive so it developed a Corporate Sustainability Reporting Directive (CSRD). The EU delegated to EFRAG (the European Financial Reporting Advisory Group) the task of developing these reporting standards[xxxiii]. The new rules formally adopted by the

European Parliament in November 2022[xxxiv] would impact companies operating in the EU, including non-EU companies, that meet two of the following criteria[xxxv]:

- More than 250 employees,
- Turnover of more than €40 million,
- Total assets of more than €20 million.

CSRD's major changes from the NFRD system involve auditing (independent checking by a third party) of the information[xxxvi]. Reporting would be mandatory, apply to more firms (less onerous requirements for smaller firms), and be better linked to financial reports[xxxvii]. Large companies would report for 2023 (so reports would appear in early 2024), but by 2026 reporting would extend to SMEs (small and medium enterprises). These changes are significant and have been welcomed by many observers, including the UNEP FI[xxxviii], as creating a more comprehensive ESG reporting system.

The US Approach

ESG reporting requirements have been more limited in US. The SEC, recognizing the need for clearer and more consistent reporting, has asked for public comments on climate disclosures:

> *"In light of demand for climate change information and questions about whether current disclosures adequately inform investors, public input is requested from investors, registrants, and other market participants on climate change disclosure." US SEC[xxxix].*

The SEC's climate disclosure requirements would require reporting on climate risks and operations including GHG emissions.

ESG reporting is thus in major flux. Supporters hope that this will increase attention on ESG issues, allow for easier understanding of ESG reports, and reduce the potential for greenwashing.

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