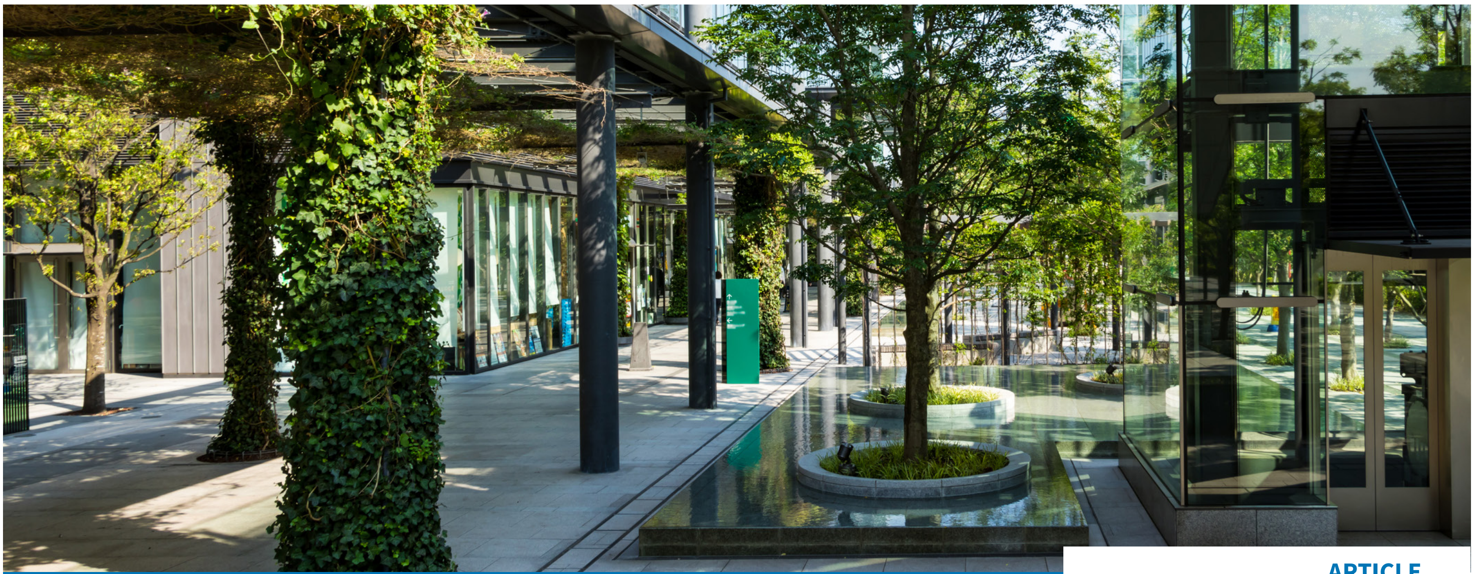

ARTICLE

The Path to Clarity on ESG Reporting and Ratings

Investors, regulators and other stakeholders demand detailed information from companies about how they are addressing ESG risks to their business. That is why companies need a robust program to collect and report this data accurately.

ESG (environmental, social, and governance) is clearly a hot investment topic right now. However, unlike some other three-letter acronyms like NFT, ESG is not an optional extra or 'nice-to-have' detail in a company's public filings and announcements. Investors look closely at how companies can mitigate risk, operate smoothly and create long-term value before making investment decisions. They expect to find the answers to their questions in companies' ESG reporting, which provides the disclosures and measurements about a companies' risks and opportunities associated with a range of issues such as climate change, labour rights and resource use. It is an important communication medium for employees, investors, regulatory bodies and other internal and external stakeholders such as ESG ratings agencies, which extract information from the reporting to build more accurate ratings.

However, sustainability reports and ESG ratings are just the visible part of the sustainability iceberg. They are underpinned, mainly out-of-sight, by a comprehensive strategic sustainability plan and approach that ensures the company is operating sustainably in addressing its broad environmental and social risks, including with respect to regulatory compliance and reputational risk management. A company's ESG reporting is its opportunity to showcase the standards it is meeting and the leadership it is showing in this area. While ratings may provide the eye-catching headlines, companies would be unwise to think they are the only or main reason to collect and present ESG data. Investors use ESG reports to better inform themselves about what they are buying and to compare different companies, adding to market efficiency. Regulators follow ESG reporting closely because it also links to market efficiency and the proper functioning of the market. It means it has to be of the highest quality.

Difficulties of ESG Reporting

Managing ESG reporting is a critical task for many companies but is complicated by the confusion caused by the large number of competing framework options. As well as the complexity of collating and verifying the myriad of information needed to address different metrics, reporting frameworks are also typically global and quite expansive which creates particular challenges in ensuring disclosure is reflective of organisational context and anticipates areas of risk under local disclosure laws.

In addition to reporting frameworks, companies try to meet ESG ratings data requirements when publishing their sustainability reports, making it even more challenging for companies to produce their reports.

The secret here is not to allow the tail to wag the dog. After developing a well-run ESG program, the next step is to create a narrative explaining how the company sees sustainability and how it is evolving to meet stakeholders' expectations. After a sustainability narrative that is true to the organisation is developed, the company can select reporting frameworks and then ensure they meet the data requirement from key ESG raters.

How ESG Investors Are Using Ratings

With the different ESG ratings that companies have to get to grips with, it is no surprise that investors use the ratings in diverse ways, too. Some asset managers use their own internal ratings or sometimes they use external ratings such as MSCI[1]. Some funds use them in negative or positive screens, ie., they add or do not add stocks to their portfolios based on certain ratings. Others use ratings to alert them in case the company is involved in any kind of ESG controversy. Investors also use ratings that are also connected with indices[2] for benchmarking these funds. They understand, however, that these ratings have failings, and are aware they cannot be the sole component of their ESG analysis.

Board Directors and ESG Performance

ESG ratings help directors understand how they sit against other companies in their sector and what different investors and stakeholders expect. But they are not the be-all and end-all and can sometimes distract directors from their core duties as directors. While directors' duties vary from jurisdiction to jurisdiction, a common one is that directors must always operate in the best interests of the company. If directors focus too much on ratings, which are high level and standardised anyway, they risk adopting an approach that may not align with the company's overall best interests. Overlooking risks or opportunities that are not reflected in that framework or being encouraged to make commitments which it cannot deliver on can create legal and reputational risks. All of this means that boards should understand that ratings are inputs – data points that can be helpful to understand what people expect – but boards are judged against their legal duties. They need to focus on and adopt policies that are specific to the company, its location, market and culture.

There are myriad other interests that go broader than the ratings, so boards must not get misled into thinking that ESG reporting is only about ratings.

Legal Risks of ESG Reporting

It is important companies monitor what they disclose, either for the purposes of ratings or other corporate filings. A few things are worth paying attention to. One is forward-looking statements, including ESG targets and climate commitments, such as commitments to net zero by 2050 or whatever date is relevant for the company. Such commitments will often be construed as forward-looking statements by regulators and investors, so the company needs reasonable grounds to underpin what they are disclosing to the market. They also need to detail risks or contingencies inherent in achieving those targets or commitments. It is important to ensure reports do not omit or understate risk items, so when you are talking about mitigation the wording will matter. Sometimes people will talk about mitigation that will only apply to one business unit but not all, or it might be relevant to one jurisdiction but not all of those that the company operates in, so the way you pick the set of risks to disclose, what you say for each of them and how you talk about the mitigation factors is important.

The increased regulatory interest and litigation in relation to ESG disclosure means that legal and risk teams should be more involved in the disclosure process. Historically, sustainability, corporate affairs or investor relations teams were responsible for disclosure, which did not require a lot of legal review, but that extra examination is becoming increasingly important because of the increasing level of regulatory scrutiny and litigation.

The Reporting and Rating Landscape of the Future

For the first time organisations such as the International Accounting Standards Board[3], TCFD (Taskforce on Climate-related Financial Disclosures[4]), the Sustainability Accounting Standards Board[5] and Integrated Reporting[6] are working together in an effort to unify how companies report on ESG and sustainability. It should be easier to measure and compare company reports and ratings in the future because companies will structure data in the same way. The net effects of ESG management will become

[1] https://www.msci.com/our-solutions/esg-investing/esg-ratings

[2] https://www.msci.com/msci-all-market-indexes

[3] https://www.ifrs.org/groups/international-sustainability-standards-board/

[4] https://www.fsb-tcfd.org/

[5] https://www.sasb.org/about/sasb-and-other-esg-frameworks/

[6] https://www.integratedreporting.org/

more quantifiable and ratings organisations will have to be more accurate, more relevant and accountable for their ratings.

ESG reporting demands companies' time and resources, but it is a vital tool for companies to be transparent with the market about how it is tackling risks and opportunities associated with a range of issues. It is a task that companies cannot afford to get wrong.

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