Why it's time to take a standard approach to *nonfinancial reporting*

Mathew Nelson, EY Global Leader for Climate Change and Sustainability Services, explains why we need globally recognized standards for reporting on environmental, social and governance issues.

Over the past 10 years, investors around the world have come to expect more detailed and useful reporting of nonfinancial performance information. A combination of the growing evidence of the link between commerce and climate change, a number of high-profile examples of poor corporate governance, and a new appreciation for the social impact of business has led investors to increase their focus on environmental, social and governance (ESG) risk.

Social media has played its part, too; in terms of reputational damage, it is far harder for corporates to avoid the spotlight today. Everyone is accountable.

Investor focus on ESG represents a long-term transition rather than a short-term trend. The more investors ask questions on ESG issues, the more they understand the core risks to business these factors can represent.

In general, companies have shown some improvement in identifying nonfinancial topics that matter to investors and the metrics that most accurately measure progress and performance. However, what is needed now are globally recognized standards for nonfinancial reporting.

NO COMPARISON

There is currently an array of standards, guidelines and frameworks that have been created by global bodies, including: the International Integrated Reporting Council (IIRC); the Global Reporting Initiative (GRI); the Climate Disclosure Standards Board; and the Task Force on Climate-related Financial Disclosures. Influential national bodies, such as the US-based Sustainability Accounting Standards Board (SASB), are also important. And, of course, the EU's Non-Financial Reporting Directive requires larger public interest entities to include annual nonfinancial statements on sustainability and diversity.

But there is no one globally accepted set of standards that is appropriate across all forms of nonfinancial information. As things stand, investors are not always in a position to compare companies on a like-for-like basis. This is because there is no clear information network that allows them to meaningfully compare businesses on ESG topics. If companies are disclosing different types of data and using different measurements, it makes it almost impossible to establish comparisons or to identify trends. In many instances, governance risk is better reported than social and environmental risk. This imbalance also needs to be addressed.

Without doubt, companies should be incentivized to provide clearer and more consistent information to investors. This is why globally recognized standards for nonfinancial reporting make perfect sense. Investors who are increasingly aware of ESG-related risks are going to view companies that comply with these standards more favorably than those that are less than transparent about how their business is governed and their environmental and social commitments.

Over time, those companies that do not comply with globally recognized standards will likely see investors increasingly sell out of their assets. And significantly, these companies will find it harder and more expensive to raise capital. This will be a strong incentive to act.

NUDGE THEORY

Clearly, however, many companies still need a nudge to make relevant ESG information available to investors. Globally recognized standards will be crucial to investors' decision-making. Nobody would dispute that a company that understands risk is going to be a better-run company than one that does not. ESG risk is a fundamental part of this equation and if a business fails to pay sufficient attention to it, it is unlikely to be successful in the longer term.

Investors report that, governance aspects aside, the main ESG factors in investment decision-making are related to supply chain, human rights and climate change risks. ESG has now become integral to the investment decision-making process and that is not going to change.

The days of investors looking purely at a company's yearly or interim financial figures are long gone — the emphasis is as much on the sustainability of the business as it is on a balance sheet. Whether it is fair trade and recruitment practices or the impact of climate change and population growth, they are demanding greater insight into all risk factors.

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Company sustainability reports provide this information to some degree, but what is included is largely at the discretion of the business itself. Sometimes the reporting is sketchy, or even promotional in nature. What a global standard would do is provide an essential framework that provides a more meaningful rationale for an investor to buy, hold or sell a stock.

Looking at the broader picture, good practices with regards to transparent and comparable ESG reporting across the board play a key role in trying to build a better working world: a world where the stewardship of the planet's environment, resources

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PROFILE
Mathew Nelson is the EY Global Leader for Climate Change and Sustainability Services and a member of the Global Financial Accounting Advisory Services executive leadership team. He has nearly 20 years' experience in providing advisory and assurance services related to sustainability, nonfinancial reporting, climate change and energy, outcomes measurement, and environment, health and safety. Prior to joining EY, Nelson worked in the petrochemical industry as an operations engineer and as a human resources analyst in the Financial Services sector. He also has significant experience in providing commercial advice to the cleantech sector and government.

and people will be central to how well business works in the future. Investors will have a clearer idea of what they are investing in, and companies themselves can gain from more structured ESG reporting, as it will help them to identify areas for improvement, which in turn could boost efficiency and productivity.

TAKING THE LEAD

For these effective reporting standards to come into being, the recent EY survey of institutional investors (*Does your nonfinancial reporting tell your value creation story?*) suggests that they view national regulators (70%) and international organizations and NGOs (60%) as being best placed to lead the effort.

However, all the relevant parties are not currently pulling in the same direction, and the idea that all national regulators will work together on this and agree on the terms is improbable. What is more likely is that further conversations and collaborations between national organizations (such as the SASB) and international ones (such as the IIRC and GRI) will lead to something workable that companies can adopt.

There are undoubtedly challenges, but global standards on nonfinancial information are a realistic proposition. After all, International Financial Reporting Standards have already set a precedent; they have been widely adopted and recognized as being in all parties' interests. What's more, widespread adoption happened relatively quickly – in less than 10 years. If strong foundations can be laid down that work for all the key stakeholders, there's no reason why something similar couldn't happen with nonfinancial reporting standards. ■

To see the fourth EY Climate Change and Sustainability Services survey of institutional investors, *Does your nonfinancial reporting tell your value creation story?*, go to ey.com/reportingvaluecreation

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