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Sustainable Insight
CAPITAL MANAGEMENT
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Setting the standard

A potentially significant change in the way companies report environmental, social and governance (ESG) information took place earlier this year. You'd be forgiven for missing it: to little fanfare, the first full set of industry-specific sustainability accounting standards were completed at the end of March.

The standards could ultimately have an important influence on the way ESG factors impact security prices. This paper explains what sustainability accounting standards are, why they matter, and how they could shape investors' decisions and corporate strategy.

What's the news?

The Sustainability Accounting Standards Board (SASB) has completed a full set of provisional standards, covering 79 industries in 10 sectors. It is now seeking feedback.

What's the significance?

According to SASB, "for the first time, we have standards that can characterize the nature of [ESG] risk and enable investors to understand and price it."

What are sustainability accounting standards?

They're similar to financial accounting standards, which govern the way a company presents its income, expenses, and other items in its accounts. Sustainability standards cover what are often called 'non-financial' items, such as environmental risks and labor relations (see box 'I say sustainability, you say… 'non-financial'?').

Aren't there existing sustainability reporting frameworks?

There are several, some of which are well-established such as the Global Reporting Initiative (see box 'Common ground or competition?'). SASB's standards differ in three ways:

1) They are designed for investors
2) They are industry-specific
3) They use the U.S. Supreme Court definition of materiality, and thus support disclosure in U.S. regulatory filings (e.g. 10-K and 20-F)

SASB standards by the numbers

SASB uses an industry classification system comprising **10** sectors and **79** industries. On average, the standards identify **5** disclosure topics for each industry and propose **14** metrics for companies to report.

Disclosure: SICM & SASB

Kevin Parker, SICM's Managing Partner, is a board member of SASB. John Willis, a portfolio manager at SICM, is a member of SASB's Metrics Committee. This report was prepared for the purpose of informing our clients and other investors about sustainable accounting standards and their potential impact on investment markets.

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How might sustainability accounting standards affect investors?

They have the potential to transform the way investors perceive ESG risks, propelling sustainable investing to the mainstream. More specifically, we think there are five possible impacts:

Complete Dataset

More companies may start to report sustainability issues, particularly in the U.S., giving investors a more complete dataset to base decisions on

Comparable Metrics

For the first time, it could become possible to directly compare companies in the same industry from a sustainability perspective

Efficient Markets

Markets could begin to price corporate sustainability more accurately, forcing changes in the way investors incorporate ESG data into their decision-making processes

Smarter Processes

As sustainability becomes a majority consideration and data quality improves, the sophistication of sustainable investment analysis should increase

Management Focus

As it becomes clearer which ESG factors drive value, companies are likely to accelerate and focus their sustainability initiatives

Clearly, none of this will happen overnight and it remains to be seen whether investors and companies will embrace the standards.

Why did SASB create them?

The aim of the standards is to help companies report material sustainability information in their Form 10-Ks (or 20-Fs for non-U.S. companies), the filings required by the Securities and Exchange Commission. 'Material' is the key word here, and SASB follows the U.S. Supreme Court's definition. Essentially, information is deemed material if it is likely to influence a reasonable investor's decision to buy, sell, or hold a security.

I say sustainability, you say... non-financial?

What are 'sustainability issues'? SASB defines them as the "non-financial risks and opportunities that affect corporations' ability to create long-term value." It groups them into five themes (see image). It's a wide spectrum, covering everything from climate change to labor relations to cybercrime.

Some of the terms used in relation to sustainability reporting are potentially confusing. For instance, not only do so-called 'non-financial' risks impact a company's finances, they are also often measured in financial units (U.S. dollars, say). Meanwhile, many people associate 'sustainability' primarily with the environment. In fact, in this context it embraces more or less the full gamut of ESG factors.

SASB's sustainability themes

- Human Capital
- Social Capital
- Environment
- Business model & innovation
- Leadership & Government

Source: SASB

Aren't companies already obliged to report material information?

Yes, Regulation S-K, which lays out the reporting requirements for various SEC filings, requires public companies to disclose material information in SEC filings. The difficulty for investors is that there is no consensus about which sustainability issues are material and no standardized way of reporting them at the industry level. SASB says it's "helping companies to comply with Regulation S-K."

Does this imply that companies are non-compliant?

That's a matter of debate best left to lawyers. The big picture here is that the growing awareness of sustainability has broadened perceptions of business value and risk. SASB argues that the way companies report needs to catch up.

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Companies already publish a vast amount of sustainability information, don't they?

Yes, but not all of it is useful for investors. According to SASB, three-quarters of its disclosure topics are addressed in SEC filings already. However, about 40% of the disclosures use boilerplate language.

In addition, almost all big companies produce sustainability reports. But SASB thinks there are several problems with the way things are done currently:

- The information in standalone sustainability reports is typically aimed at multiple stakeholders, so it's less useful for making investment decisions
- According to SASB, about 75% percent of the sustainability information currently reported in sustainability reports is not material
- Where metrics exist, there's little consistency in which ones are used, making it difficult to compare companies

SASB aims to make sustainability information "decision-useful" for investors by focusing it on material issues, standardizing it, and concentrating it in the 10-K.

How?

SASB has identified which sustainability factors are likely to be material to each industry , both through its own research and by convening working groups of investors, businesses, and other stakeholders.

A core part of its standard-setting process is to map out the relationships between financial metrics and sustainability issues. For instance, in the chemical sector there is an obvious connection between hazardous waste management and the revenues and costs of many chemical companies.

Its next step was to develop a standardized way for companies to measure issues like this and report them in their 10-Ks (see SASB's Implementation Guide). So for Hazardous Waste Management, one quantitative metric is requested:

- Amount of hazardous waste, percentage recycled; metric tons / %

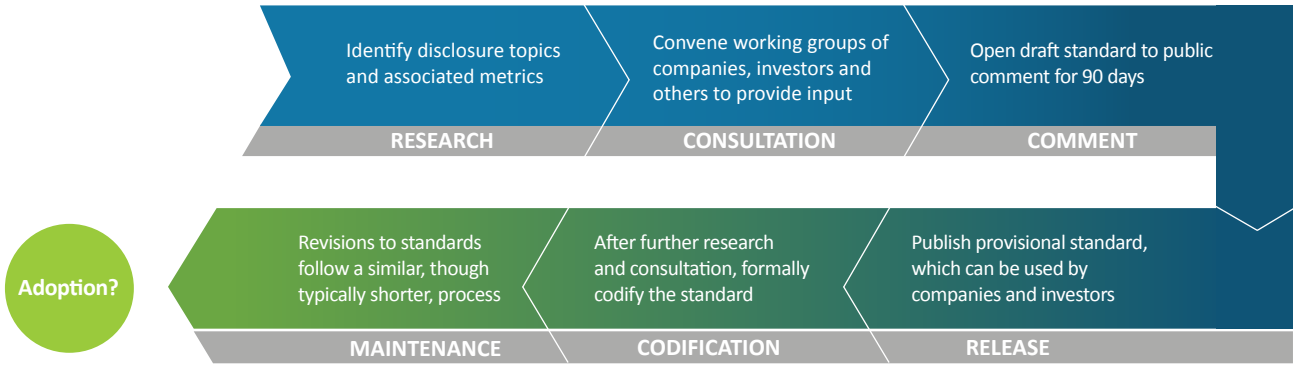
Other material issues for Chemical companies include Safety and Environmental Stewardship of Chemicals and Genetically Modified Organisms. Three quantitative and one qualitative metrics are requested:

- Percentage of products that contain substances of very high concern (SVHC); % by revenue
- Percentage of products that contain acutely toxic pesticides; % by revenue
- Percentage of products by revenue that contain genetically modified organisms; % by revenue
- Discussion of strategy to manage chemicals of concern and develop alternatives

The above has been simplified considerably. The standards themselves are more detailed and include guidance on how the metrics should be calculated.

How to set a standard

It takes SASB about a year to develop a provisional standard. It's process is as follows:



Source: SASB & SICM

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What topics do SASB's standards address?

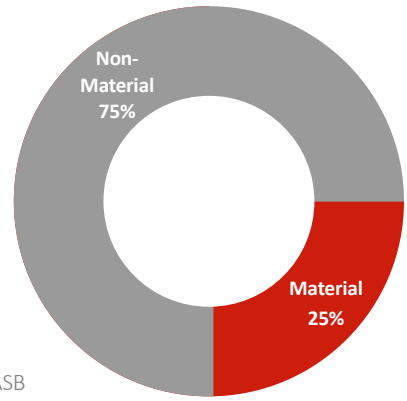
'Sustainability' in this context covers a huge range of things (see box 'I say sustainability, you say… 'non-financial'?' on page two). For each industry there is an average of five broad topics and 14 metrics, three-quarters of which are quantitative. Many of the metrics in the standards are actually in use already. This is intentional – and hardly surprising given that the standards were developed in consultation with companies, investors and other stakeholders. About 2,800 participants took part in its industry working groups, affiliated with companies (31%), investors (31%), and public interest groups and intermediaries (37%).

Do companies have to use SASB's standards?

No, they're optional. This is in contrast to the standards set by the Financial Accounting Standards Board, which everyone has to follow. Even if a company decides to use SASB's standards, it's up to them which ones to use: put another way, the onus is on the company to decide what sustainability information is material.

Mostly immaterial

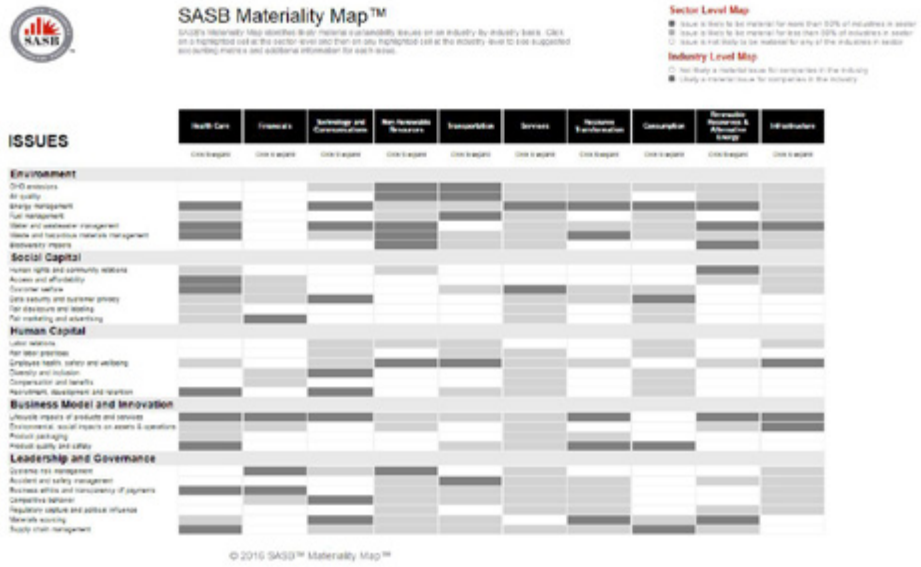
According to SASB, most of the information published in standalone sustainability reports is not material.



Source: SASB

Mapping materiality

SASB says its standards will help companies identify and report the sustainability issues that are material for them. See its Materiality Map for details.



Source: SASB

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So what's the difference between SASB and FASB?

They're not affiliated and have different roles. To explain: the SEC has the statutory authority to establish financial accounting and reporting standards for publicly held companies. Since 1973, it has delegated this task to FASB. The SEC recognizes FASB's standards as authoritative and requires companies to use them in preparing their financial reports.

SASB has not been appointed by the SEC to set standards. It grew out of a Harvard University study into industry-specific material issues and their associated indicators. Spurred by a positive response, the authors decided to develop a full set of indicators, which led to the creation of SASB. The organization is currently a non-profit funded primarily by donations, though it's aiming to transition to a business model based on earned income. SASB is accredited to set standards by the American National Standards Institute (ANSI).

Common ground or competition?

SASB is keen to emphasize the common ground it shares with other organizations working to improve sustainability reporting; others say that a battle for dominance is taking place.

Investors and companies could be forgiven for being confused. On April 19 2016, three weeks after SASB announced the completion of its provisional standards, the Global Reporting Initiative released the first draft of its GRI Sustainability Reporting Standards. The announcement completed the first phase of a GRI project to turn its existing guidelines into formal standards.

Calls for consistency: Not surprisingly, there have been calls for "greater coherence, consistency and comparability" between corporate reporting frameworks. In 2014, these resulted in the formation of the Corporate Reporting Dialogue, which brings together GRI, FASB, SASB and other groups. Though sharing similar aims, each of the organizations takes a different approach. For instance, SASB focuses on helping companies include material sustainability information in their SEC-mandated Form 10-Ks; GRI's reporting framework is international and aims to cater to the needs of multiple stakeholders, not just investors.

Working together: The various organizations point out that they sometimes work together: in drawing up its standards, SASB says it drew on existing reporting frameworks where applicable. Moreover, as one consultant noted, various frameworks can be used together: "[A company could use] the SASB standards to guide the disclosure of material sustainability issues in a 10-K form for investors, the GRI framework to guide the development of a voluntary sustainability report for all stakeholders, and the IIRC guidelines to inform the development of an integrated annual report, if desired." But long-term it's likely that a common sustainability reporting framework will ultimately emerge, at least for large companies.

Corporate reporting dialogue: Who's who?

In response to concerns that there are too many sustainability reporting frameworks, the eight members of the Corporate Reporting Dialogue are exploring ways to coordinate initiatives.

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Could SASB's standards become mandatory?

It's possible. SASB says it doesn't mandate disclosure and is merely providing "helpful market infrastructure" to aid companies in complying with existing laws on materiality. But some lawyers believe "there is a possibility that [SASB's] standards will influence the law of materiality and could become de facto disclosure requirements."

Others have warned that SASB's standards may be "imposed upon companies by special-interest investors and other groups through effectively threatening companies with adverse publicity and other consequences in the event of non-compliance." Finally, the SEC may eventually mandate use of SASB's standards. SASB says it isn't pushing for this, but it has close links to the regulator: in fact, former SEC Chair Mary Schapiro is Vice Chair of SASB's board.

It's also possible that an insufficient number of companies and investors will use SASB's standards to make them viable. This could happen if another organization's reporting framework becomes dominant or if the standards themselves are considered unworkable.

What's the SEC's current position on sustainability standards?

An April 2016 'Concept Release' inviting public comment on modernizing disclosure suggests the SEC is open to the idea that reporting needs to change. The Commission is seeking input on eight questions related to ESG disclosure. Meanwhile, legal actions by New York's Attorney General against energy companies over climate-related disclosure have stepped up the pressure on the Commission to address the issue.

What do companies and investors think about SASB's standards?

It's fair to say there's a range of opinion. SASB has plenty of supporters. It says the sustainability standards benefit companies because they:

- Focus management on the issues that drive value
- Help them comply with existing materiality requirements
- Offer a cost-efficient way of collecting and disseminating sustainability information
- Improve investor communications and ensure that sustainability performance is recognized

More generally, many investor groups are aligned with SASB's broad aim of improving transparency around sustainability – as highlighted by recent criticism of the SEC for being "asleep at the wheel" over climate risk disclosure.

... and the critics?

Some industry groups have voiced concerns about the standards and the way they were compiled. These letters from water and real estate companies give an idea of the strength of feeling. In 2014, an SEC Commissioner criticized SASB for attempting to "prescribe what should be in corporate filings" without authorization. SASB's response is here. Other criticisms include the following:

- The standards add to the disclosure burden on companies, which already face many demands for ESG-related information
- Various sustainability reporting frameworks exist, at both the global and industry level
- Some say SASB's industry classification system fails to take account of the characteristics of certain types of business (e.g. water companies)
- Some groups have complained that they weren't adequately consulted
- Some people think that sustainability issues are too complex and company-specific to be captured by industry-level standards

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How many publicly traded companies are using SASB standards in their SEC filings?

None yet. SASB expects companies may wait until the standards are codified. In any case, it will take time for businesses to incorporate them, not least because of the amount of legal review required. Nonetheless, participation in industry discussions concerning the standards suggests many companies are starting to look at them.

Are many investors embracing them?

Hard to quantify. Some influential institutional investors – including CalPERS and Harvard Management Company – are backing the standards. Meanwhile, SASB is partnering with other companies to develop investible products and data services for investors based on its standards and industry classification system.

What happens next?

A consultation period on SASB's key principles and processes runs until July 2016. SASB will continue to review its standards over the next year or so, seeking feedback from companies, investors, and other stakeholders.

From a wider perspective, sustainability reporting is clearly in transition. Companies, investors, regulators and lawyers are thrashing out which sustainable issues affect corporate value and the extent of companies' obligations to disclose them.

It remains to be seen whether SASB's standards will form part of a future market infrastructure. What seems certain is the direction of travel: the volume, quality and impact of publicly available ESG data will continue to grow. Investors need to be ready to adapt their investment approaches in response.

i. SASB created its own industry classification system, grouping companies according to their exposure to similar sustainability issues. As noted above, the system has come under criticism.

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