ESG Backgrounder & Conference Summary

Professional accountants are becoming increasingly involved with the measurement, disclosure, monitoring, decision making and strategizing related to ESG activities. They need to understand the fundamentals of ESG sufficiently to undertake these responsibilities and to appreciate the points made by the speakers at the PAC 2020 Conference on Professional Accounting Futures that covered ESG challenges. This ESG Background Summary is designed to provide an understanding of some of those fundamentals.

In this summary, we blend ESG fundamentals and the PAC 2020 Conference discussions under five themes:

- ESG: Context and Definition(s)
- ESG: The Good News
- ESG: The Bad News
- ESG: The Hopeful News
- ESG: Roles for Accountants
- Concluding Thoughts

Panelists who discuss the topics are named to the side of the text and in the Endnotes.

We hope to pique your interest in ESG developments, inspire accounting professionals to become involved, and invite you all to watch for PAC's Sixth Annual Conference on Accounting Futures in the fall of 2021.

ESG: Context and Definition(s)

This section provides some historical context for the origin of ESG through the impetus of the United Nations and current context, evolution, and definitions provided by conference panelists.

ESG is loosely used as a synonym for corporate social responsibility, sustainability. social responsibility, etc. More explicitly, ***environmental***, ***social*** and ***governance*** issues were linked to investment decisions (or **responsible investing**, **socially responsible investing**) in a 2004 United Nations-initiated report called ***Who Cares Wins***.[1] Through it, 50 major financial institutions made recommendations to "better integrate environmental, social and governance issues in analysis, asset management, and securities brokerage" in support of the UN Global Compact Principles for a more stable and inclusive global economy.[2]

The "E" in ESG: *Environment*

Jean Charest
Linda Coady
Anton Tabuns

In 2015, through the Paris Agreement,[3] many countries agreed to "net-zero"[4] economies by 2050: the balance between greenhouse gas (GHG)-producing and GHG-reducing industries to reduce net GHG emissions to zero to stabilize climate change.[5] Certainly not the only environmental component of ESG, **carbon reduction** has the highest profile, the most agreement, and the greatest global impact. **For environmental factors, the "E" in ESG**, think resource use (energy, water, raw materials) and waste management (pollutants, GHG).[6] [7]

The "S" in ESG: *Social*

Jean Charest

Daniel Hicks

Flash forward to 2020, and the world is still recovering from the 2008-2009 recession. Growing are populism, authoritarianism, nationalism, wealth inequality, and voices against systemic discrimination. Exposed by the COVID-19 pandemic are inequitable health, labour, employment safety, and financial impacts along gender, income-level, and racial lines. Accelerated by COVID-19 are the development of the digital economy, increased protectionism, de-risking of supply chains, and the need to address systemic racism and a lack of diversity/pay equity at the executive/C-suite levels in any plan for recovery. **For social factors, the "S" in ESG**, think labour practices, human rights, diversity and inclusion, corruption, and product safety.

The "G" in ESG: *Governance*

Gigi Dawe

A top-priority of directors includes overseeing strategy, yet because of external factors (e.g., economic volatility, cybersecurity, the pandemic), boards of directors may struggle to fulfill this responsibility. Building back better is an opportunity to re-visit supply chains, build resilience, spur clean competitiveness and inclusive growth on the path toward net zero, but all of these need a long-term strategic vision.[8] **For governance, the "G" in ESG**, think boards of directors (independence, competence, fiduciary duty), executive and director compensation, ethics, compliance, internal controls, enterprise risk management (environmental, technology/digitization, data security), strategy.

ESG: The Good News

This section looks at ESG and value creation, demand for ESG reporting, issues associated with reporting, and the impetus for integrated financial/ESG reporting. We refer again to the historical context (Figure 2) because we see how notions of value creation change over time and differ depending on perspective. So, here we look at:

- ESG and Value Creation: Many Perspectives
- Investor demand for ESG Disclosure and Reporting

  - Investor Demand Increases
  - Voluntary Corporate Disclosure Increases
- ESG Reporting and Disclosure: The Issues
  - Comparability, Complexity, Competition, Cost, and Confusion: “ESG 1.0”
  - Still Early Days: ESG and Financial Reporting are not Integrated
- Toward Integrated Financial/ESG Reporting
  - Harvard’s Impact Weighted Financial Accounts Initiative: “ESG 2.0”
  - Task Force on Climate-related Financial Disclosures (TCFD)
    - The TCFD Framework
    - Growing Support for the TCFD

ESG and Value Creation: Many Perspectives

In 2004, *Who Cares Wins*[9] said that “good management of ESG issues can **contribute to shareholder value creation**” through a number of drivers[10] [Emphasis added.] (See Figure 2).

Figure 2: Initial Notions of ESG and Shareholder Value Creation
Source: *Who Cares Wins*[11]

Good Management of ESG Issues Can Contribute to Shareholder Value Creation

- Early identification of emerging risks, threats, management failures
- New business opportunities
- Customer [and employee] satisfaction and loyalty
- Reputation as an attractive employer
- Alliances and partnerships with business partners and stakeholders
- Enhanced reputation and brands
- Reduced regulatory intervention
- Cost savings
- Access to capital, lower cost of capital
- Better risk management, lower risk level

Optimistically, ESG is now sometimes **equated** to ***value creation*** because of the critical role that management of ESG factors play in an organization’s ability to create value.[12]

Rosemary McGuire

Dominique Barker

For **some analysts**, considering ESG factors is nothing new. ESG can be used as a ***concept***; a form of risk management; a frame for the future; the discount rate; the denominator in a free cash flow analysis. Considering ESG factors is way of formalizing a risk framework that is explicit in what risks are being taken into account, how they’re measured, and how they’re integrated into investment decisions. When evaluating a company, these analysts ask: What investment risks and opportunities does a company have in its future? Will what management does today have value in the future?[13]

For **capital markets**, how will ESG issues (like climate change) affect investees' future financial performance? What are the risks to investors?

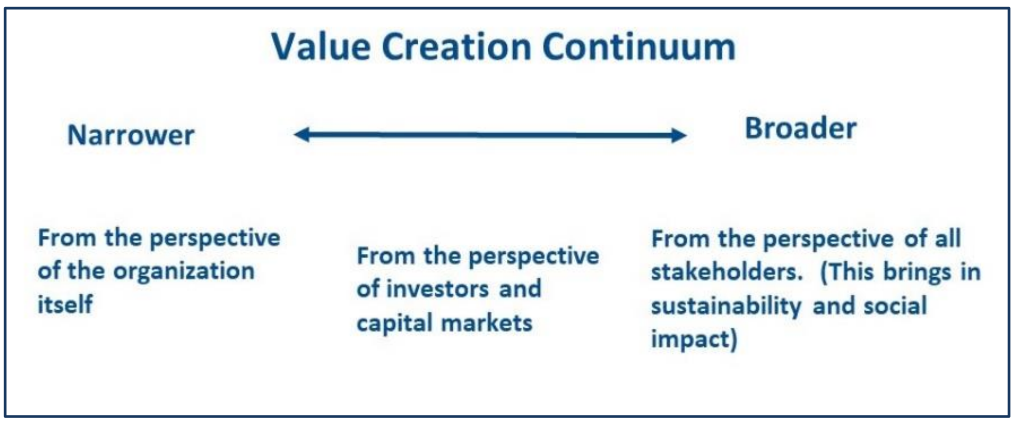
Shiva Rajgopal
Anthony Scilipoti
Carson Block

To **skeptical analysts and investors**, however, that value creation is a **chimera**, because companies' ESG measures – often intangible, hard to measure, and non-financial – do not necessarily translate into higher ***alpha***; that is, lower risk or higher profits against a benchmark index.[14] [15]

Rob McLean

ESG's various declensions depend on that **value creation perspective** (Figure 3). CPA Canada's provisional definition of value creation is: "the process by which an organization creates the potential for a) revenue and net income that can be realized in the future, and/or b) future benefits for the organization's stakeholders."[16]

Figure 3: Value Creation Depends on Perspective[17]
Source: Panelist Rob McLean



The perspective of the **Business Roundtable** seemed to move, in 2019, from the narrower view of value creation (**shareholder perspective**) to a broader view (**stakeholder perspective**).

Jean Charest
David Beatty

Signatories to a revised ***Purpose of the Corporation*** said that while corporations each have their own purpose, they share a fundamental commitment to **all of their stakeholders**: customers, employees, suppliers, communities, and shareholders, but **not shareholders alone**.[18]

Investor demand for ESG Disclosure and Reporting

Investor Demand Increases

Jody Grewal

Between 1995 and 2018, investor demand for sustainable and responsible investing in the U.S. grew almost exponentially. In the U.S. by 2018, "one of every $4 invested under professional management [was] in sustainable, responsible and/or impact investments."[19]

Table 1: The IFC, ESG, and Better Returns
Source: Derived from information from Panelist Elizabeth White

The IFC found that...

- Clients with good corporate governance (CG) practices outperformed those with poor practices.[20]
- Clients with high environmental and social (E&S) performance outperformed the MSCI emerging market index.*
- Clients with poor E&S performance underperformed index.[21]

* An index created to measure equity market performance in global emerging markets.

The World Bank's International Finance Corporation (IFC) finances companies in emerging markets as part of its mission

- to end poverty by 2030 and
- to build share prosperity in a sustainable way.[22]

Elizabeth White

The IFC found that its clients with good ESG practices outperformed those with less-good practices. (See Table 1.) The results, "showing correlation, not causality," are central to the IFC's thinking about the business case for ESG adoption: they mean better business returns and a higher probability of investment success.[23]

Elizabeth White

The IFC, then, sees ESG as a ***complement*** to the growing demand for **impact investing**[24] -- i.e., making a return while doing good. "Most impact investors will screen for, and manage, ESG risk as part of their investment practices."[25]

Voluntary Corporate Disclosure Increases

To gain access to that increasing sustainability capital, voluntary corporate disclosure also increased. For example,

> *"In the early 1990s fewer than twenty organizations produced corporate sustainability reports; by 2019 more than 10,000 publicly listed companies produced such a report..."*[26]
>
> *Panelist Jody Grewal and George Serafeim*

ESG Reporting and Disclosure: The Issues

In 2019 the chair of the International Accounting Standards Board (IASB) said that financial and sustainability reporting would be one-and-the-same if the price of a product reflected its true cost, including its cost imposed on the environment.[27] In this section, panelists reflect on the difficulties of measuring ESG impacts before they can be translated into costs.

Comparability, Complexity, Competition, Cost, and Confusion:[28] "ESG 1.0"

Rosemary McGuire
Jody Grewal
Linda Cody
Daniel Hicks

Despite the increased amount of company disclosure, the level of quality, comparability, reliability of these disclosures can be confusing and inconsistent, despite a 25-year proliferation of reporting frameworks, standards, industry and stock-market guidance, and ESG ratings organizations.[29] [30](For a sample, see Table 2.)

Simon MacMahon
Sakis Kotsantonis

Best practice could be considered linking ESG issues to core business drivers in accordance with a global standard, such as the Global Reporting Initiative (GRI) or Sustainability Accounting Standards Board (SASB). However, only about 12% of companies report to this level globally.[31] Even so, those standards could be called "**ESG 1.0**," because they look at company **intentions**, rather than **outcomes**.[32]

CPA Canada has identified about 75 ESG "…frameworks, standards, guidance, methodologies, platforms and toolkits intended to help organizations develop a better understanding of the economic, social, and environmental impacts."[33] (For a sample, see Table 2.)

Table 2: The Reporting Ecosystem: Examples of Reporting Standards and Frameworks[34]
Source: Panelist Rosemary McGuire

Value creation/ESG reporting solutions

CDP	▪ Runs the global disclosure system for investors, companies, ...to manage their environmental impacts
CDSB	▪ Committed to advancing and aligning the global mainstream corporate reporting model to equate natural capital with financial capital
SASB	▪ SASB's mission is to help businesses around the world identify, manage and report on the sustainability topics that matter most to their investors
Embankment Project for Inclusive Capitalism	▪ We came together in pursuit of a single goal: to identify and create new metrics to measure and demonstrate long term value to financial markets
GRI	▪ Helps businesses and governments understand and communicate their impact on critical sustainability issues
<IR>	▪ To align capital allocation and corporate behaviour to wider goals of financial stability and sustainable development through the cycle of corporate reporting and thinking
IMPACT MANAGEMENT PROJECT	▪ A forum for building global consensus on how to measure, report, compare and improve impact performance
TCFD	▪ The work and recommendations of the Task Force will help firms understand what financial markets want from disclosure in order to measure and respond to climate change risks and encourage firms to align their disclosures with investors needs

5 CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA COMPTABLES PROFESSIONNELS AGRÉÉS CANADA

Simon MacMahon

"A growing number of organizations offer to help decision-makers understand sustainability performance by coming up with some sort of index or ranking."[35] These third-party ESG screening- and ESG ratings-, research- and data-providing organizations include **Sustainalytics**, one of the oldest and possibly the largest.[36] Companies like Sustainalytics may use existing frameworks and standards and measures of their own and aggregate scores to produce ESG ratings for financial-market clients.

Naomi Soderstrom

These organizations are sometimes criticized because the reporting/rating coverage and methodologies can vary greatly among providers;[37] [38] the same data can be interpreted differently by different raters;[39] and because scores may seem like black boxes.[40] As businesses, their methodologies are proprietary, which may account for differences between ratings,[41] and clients may see score breakdowns that appear aggregated for non-clients.[42]

Still Early Days: ESG and Financial Reporting are not Integrated

Jody Grewal

For investors to gauge firm performance, financial information alone is incomplete, because it is a "lagging indicator of firm performance:"[43] a view of the *past*. Sustainability is *forward-looking*, so backward-looking metrics are not useful.[44]

While financial reporting has matured because of internationally recognized standards, the breadth of information and variety of users for ESG reporting make it more complex.[45] The plethora of frameworks for ESG/sustainability reporting and a lack of globally accepted standards show that it is still a young field. And although ESG information is used as a ***complement*** to financial reporting for evaluating current and future corporate performance,[46] typically, it is non-financial information reported separately from financial statements.

Toward Integrated Financial/ESG Reporting

Among the most recent developments in the reporting ecosystem are methods of **integrating** ESG and financial reporting.[47] [48] Two examples, very different in approach, come from Harvard Business School and the Financial Stability Board's Task Force on Climate-related Disclosures (TCFD).

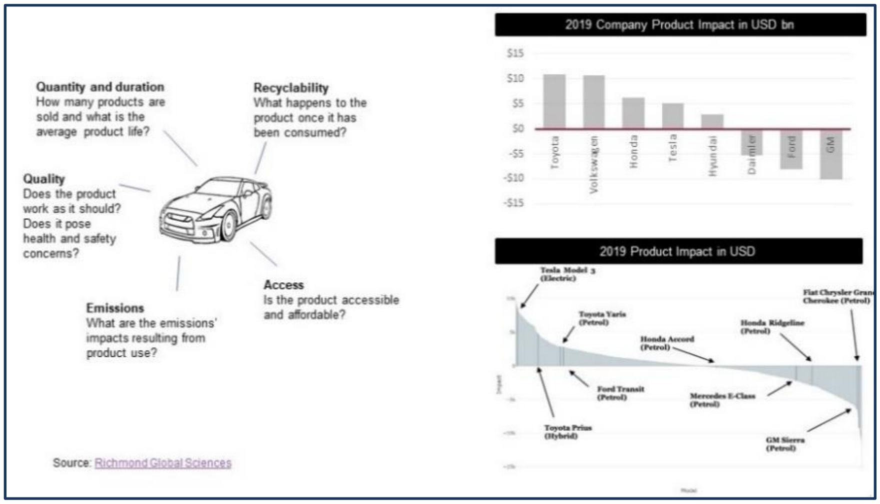
Harvard's Impact Weighted Financial Accounts Initiative: "ESG 2.0"

Sakis Kotsantonis

Traditionally, a company's success is measured as profits, and externalities caused by its products are not really measured or priced. Harvard Business School's **Impact Weighted Financial Accounts Initiative**,[49] aims to integrate a company's financial, social, and environmental performance. To do this, the costs of externalities caused by a company are estimated, translated into ***currency***, and deducted from the company's profits. So, within an industry, leaders and laggards emerge, based on their products' impact on the environment: their ***environmental intensity*** (how they utilize environmental resources). (See Figure 4.) For most industries, environmental intensity will be associated with lower market valuation, lower revenue, and higher risk.[50]

Importantly, displaying financial impact performance as part of financial accounts/reporting allows for the use of existing financial and business analysis tools: that places the system in the accountants' realm. And, the data are not based on ***policies*** or ***intentions*** or ***future targets***, but actual ***outcomes***: call it "**ESG 2.0**." So, managers and governments can make better decisions on how to reduce impact/create incentives.

Figure 4: Example of Product Impact and Variation Across Companies[51]
Source: Panelist Sakis Kotsantonis



Task Force on Climate-related Financial Disclosures (TCFD)

Every panel contributed information about the TCFD. This part looks at TCFD origins, its associated framework and growing support.

By 2015, the "E" in ESG – specifically, the carbon in climate change -- became an **imperative**. The G20's Financial Stability Board's chair[52] Mark Carney, then-governor of the Bank of England, said in his speech to insurer Lloyd's of London,

> *"The challenges currently posed by climate change pale in significance compared with what might come."*
>
> *Mark Carney, Governor of the Bank of England; Chair of the Financial Stability Board, September 2015*[53]

The week before that speech, the FSB considered "…recommending to the G20 summit that more be done to develop consistent, comparable, reliable and clear disclosure around the carbon intensity of different assets." By December 2015, the recommendation had been made and the **Task Force on Climate-related Financial Disclosures** was born.

Its goal would be **stability of financial markets** reflecting the perspective of investors, lenders, and insurance underwriters. Its objective would be identification of information to appropriately assess and price climate-related risks and opportunities.[54]

"…[T]hat which is measured can be managed. Information about the carbon intensity of investments allows investors to assess risks to companies' business models and to express their views in the market…[And] supply creates demand. This means that the act of producing new products creates income and profits that ultimately finance the demand for them."

Mark Carney, Governor of the Bank of England; Chair of the Financial Stability Board, September 2015[55]

The TCFD Framework

Anton Tabuns

"TCFD" now describes the task force and the framework, still under development, issuing from its 2017 recommendations.[56]

See also:
Jean Charest
Rosemary McGuire
Linda Coady

The TCFD is a "… a comprehensive, practical, and flexible framework for corporate disclosure of climate-related risks and opportunities,"[57] related to transition to a lower-carbon economy, under themes of governance, strategy, risk management, and metrics and targets.[58] (Figure 5) It is adoptable by all organizations[59] and "brings the 'future' nature of issues into the present through scenario analysis."[60]

Figure 5: TCFD Recommended Climate-related Financial Disclosures[61] [62]
Panelists Linda Coady and Anton Tabuns

The Relationship Between Frameworks and Standards

"Frameworks and standards are complementary and are designed to be used together."[63]

Frameworks -- like TCFD -- provide **guidance** on "…the types of information that should be disclosed or considered,"[64] while standards (some also called frameworks; recall Table 2) "…provide specific, detailed, and replicable requirements for what should be reported for each topic, **including metrics**." [65] [Emphasis added.]

As part of its mandate, the Task Force assessed the alignment with its recommendations of many existing voluntary and mandatory reporting frameworks. [66] It named five, in particular, including SASB. [67]

Likely as a result of TCFD prompting, in 2020, those five leading sustainability and integrated reporting organizations made a commitment to work together to develop a **comprehensive reporting system**. It would incorporate disclosures that:

- reflect an organization's significant impacts on the economy, environment, and people
- are material for enterprise value creation
- meet the needs of capital markets and other stakeholders.[68] [69]

Growing Support for the TCFD

Mark Carney was Chair of the TCFD until 2018. Michael Bloomberg has been Chair since 2018.[70] With such influential leaders, it is perhaps no surprise that the TCFD recommendations continue to gain support from banks, asset managers [including BlackRock[71]], pension funds,[72] insurers, and others[73] as best-practice for climate-related disclosures that will be integrated into mainstream financial filings.[74]

Anton Tabuns

Anton Tabuns

In 2019, CPA Canada studied disclosures on climate-related risk from 40 Canadian TSX-listed public companies and the degree of their alignment with TCFD recommendations. The study[75] showed that only one company "…disclosed in all four TCFD-recommended categories, and 11 sub-categories."[76] With growing global acceptance of the TCFD, Canadian company alignment is expected to increase.

Jean Charest
Rosemary McGuire

The 2020 pandemic may have also increased Canadian company alignment with the TCFD, because receipt of relief funding from the Canadian government[77] was contingent upon companies showing climate disclosure in annual reports consistent with TCFD recommendations.

ESG: The Bad News

Some panelists presented evidence that tempered some of the optimism around ESG. They "busted" myths, reported on ESG-message inconsistencies, and outlined problems with corporate behaviour – particularly short-term, rather than long-term planning horizons -- that are barriers to true environmental, social, and governance changes. In this section, we look at:

- "Busted" ESG Myths
- Stakeholder-Focused Governance: Is it an Illusion?
- Cautionary Tales

"Busted" ESG Myths

- **Europeans are ahead of North Americans: Follow their lead.** Panelist Stefan Reichelstein busted this myth. He said,

> *"European companies and regulators aren't any closer than their U.S. and Canadian counterparts in terms of [agreeing to] a set of comprehensive reporting and measurement standards for ESG activities….[T]hat shouldn't surprise us too much, simply because the range of ESG activities is so broad and the boundaries [are so] fuzzy that having anything akin to the financial reporting standards we are used to is probably a long, long distance off."*

In other words, reporting standards may take time. Even the TCFD, said Panelist Anton Tabuns, had a five-year planning horizon.[78]

- **ESG investing creates alpha.** Panelist Shiva Rajgopal challenged this myth.

> *"An ESG heavy portfolio is typically long on tech and short on energy; tech has done well in stock markets, but energy has suffered. And tech gets systematically higher ESG scores than energy. Hence, ESG outperformance is simply tech outperforming energy stocks."[79] Will returns -- stripped of subsidies -- be positive for investors? Taxpayers?[80] Narrowing the gender pay gap does not seem to be associated with increased future performance.[81]*

- **BlackRock's Proactive Messaging.** BlackRock is the world's largest asset manager. While more than one panelist applauded BlackRock's ESG-promoting messaging, Panelist Carson Block challenged it. In his 2020 letter to clients, CEO Larry Fink wrote,

> *"Climate change has become a defining factor in companies' long-term prospects…[A]wareness is rapidly changing, and I believe we are on the edge of a fundamental reshaping of finance…Investors are increasingly…recognizing that climate risk is investment risk. Indeed, climate change is almost invariably the top issue that clients around the world raise with BlackRock."[82] [83]*

Yet,

> *"BlackRock's hesitance to back climate-related shareholder proposals contrasts with warnings it has raised about financial impacts on businesses from climate concerns…Their limited support for other shareholders' climate-related proposals highlights a broader pattern of deference to management at the companies in their stock portfolios, according to a Reuters analysis of their proxy voting records."[84] [85]*

Stakeholder-Focused Governance: Is it an Illusion?

Panelists David Beatty and Shiva Rajgopal identified governance issues as barriers to the long-term thinking that sustainability/ESG investments require.

- **Marketing rather than market-moving?** Disappointingly, "Business Roundtable (BR) signatories have systematically worse environmental, labour, and lobbying records than very similar firms that did not sign the BR statement."[86] The 2019 statement by the BR "…represented a public-relations move rather than a commitment to bring about meaningful change."[87]
- **Escaping public scrutiny?** From 1997 to 2015, the number of companies on the U.S. stock markets fell by 50%, from 7,428 to 3,754, from delisting, low IPO activity, and acquisition.[88] The trend is similar for the U.K. market.[89] While all traded companies must comply with securities laws, unlisted

firms can more easily escape: public scrutiny, the mandatory reporting required of public companies, and activist investors.

- **Activist-investor takeovers.** If a company doesn't look profitable, relatively new players in capital markets called **activist investors** may buy enough shares to influence how it is run and may take it private... Global activism is a huge industry: in 2019, 666 firms[90] did nothing else but appraise company performance against what they thought they could make that company worth in the near term."[91] They target companies of any size in any market-cap segment in any part of the world.[92]
- **"Short-termism" instead of a long-term view.**
  - **Average holding periods** for public company shares in 2017 were only 5.1 years in the U.S., and only 3.9 years globally.[93]
  - **CEOs inflate short-term results to the detriment of long-term performance** because of pressure from Wall Street analysts and investors for profitable quarterly results.[94]
    - Because a significant portion of CEO pay is in the form of shares/stocks and stock options and performance pay, CEO compensation is directly tied to ***shareholder*** value.[95]
    - CEOs—with terms of only 7 years, on average—have a limited time to make their own fortunes.[96]
    - Planning horizons are short. A McKinsey Quarterly survey of 1,000 C-suite executives and board members in late 2015/early 2016 found that "pressure to generate strong financial results within two years was growing."[97] A 2020 McKinsey/ FCLTGlobal study shows that COVID-19 has placed even more short-term demands on executives, and they've postponed or halted long-term growth projects.[98]

Therefore,

- **Shareholderism is alive and well.** "The interests of corporate leaders and shareholders are firmly entrenched in the compensation plans in place at almost all of the Fortune 500 companies in the S&P 500 index…So, at the moment, the centre of gravity is solidly on making quarterly earnings and nothing else.[99]

Cautionary Tales

"If businesses could be operating profitably or more profitably in ways that are sustainable or impose fewer externalities on the world, they'd be doing it."

Panelist Carson Block[100]

Panelists Anthony Scilipoti, Carson Block, Daniel Hicks, and Sonia Struthers, in helping to make sense of measurements provided cautionary advice, including these points:

- What can be measured can be audited, but what can't be measured should be treated with caution.[101]
- Good ESG ratings may obscure poor financials. The small print in the prospectus is still important to read. Quality and clarity of accounting and disclosure should affect the level of trust to give to a company's disclosures.[102]

- ESG reporting may result in form over substance, without getting reform.[103]
- Don't forget the basics: quality and clarity of accounting and disclosure; cash flow sustainability; balance-sheet risk; business-operations risk; corporate governance, including management compensation alignment with interests of shareholders. Is the company set to delivering positive returns over the long term? [104]
- A lot of funds flow into ESG-type stocks. So, if a company does have an excellent ESG grade, the fund flows might push the stock price higher even if the actual cash flows and profits of the company decline. [105]
- While relying on ESG ratings and ignoring financial statements is ill-advised, the opposite is also true: saying a company is financially healthy if not healthy in corporate social responsibility (e.g., Black Lives Matter), is unacceptable.[106] Some U.S. companies who adopted lofty goals with respect to diversity are now being sued for lack of results.[107]

ESG: The Hopeful News

Despite the "bad news" about barriers to ESG reporting and barriers to changing corporate behaviour and investment, many panelists reported on forward changes that cannot be denied. In this section we cover:

- Counter-actions to Short-termism
- Changing Roles of Directors
- Consolidation of Reporting Frameworks
- Mandatory versus Voluntary Disclosure
- Technology and the Changing Reporting Environment

> *"We should remember that companies also pushed back when they were faced with mandated financial reporting in the 1930s. For ESG, it's early days. We're nowhere near the level of standardization that financial accounting has. We need to bear this in mind, both when we criticize sustainability reporting and when we praise it."*
>
> *Panelist Jody Grewal*

Counter-actions to Short-termism

Panelists David Beatty, Susan McGeachie, Daniel Hicks, and Elizabeth White said some organizations and individuals are taking a long-term view. They --

- **Advocate for "long-termism."** McKinsey & Company and the FCLT (Focus Capital on the Long Term) are trying to convince CEOs and boards to change short-term thinking.[108] The FCLT was formed to develop "…practical tools and approaches that encourage long-term behaviors in business and investment decision-making."[109]
- **Find "patient" capital.**
  - The Long-Term Stock Exchange[110] is a new exchange in the U.S. for long-term investment.

- Some lenders offer longer-term loans and leases -- “patient capital." Some green or transitional technologies could be commercially viable today, but investors may not understand them, particularly if they are looking for a short payback period. Governments can only invest so much, and more private investment is needed. Companies may be able to shape their investor base by not accepting capital from impatient investors, and there are strategies to do this.[111]
- Some impact investors may accept a wider definition of return, as long as measures of success are defined and audited.[112] Others will screen for, and manage, ESG risk as part of their investment practices.[113]

- **Some companies…**
  - Stay private for a longer time.[114]
  - Adopt a dual-class share structure at IPO time adopt to insulate from activist investors.[115]
- **Some leaders…**
  - Are committed to progress over the long-term (e.g., Paul Polman’s initiated Sustainable Living Plan when at Unilever in 2017;[116] Michael Dell of Dell Technologies has a long-term plan for corporate social responsibility[117]).
- **Some asset managers…**
  - Offer customized index portfolios for investors,[118] which might avoid the dissonance between short-term returns and ESG- or values- or mission-based investments identified by several panelists.[119]

Changing Roles of Directors

Panelists Sonia Struthers, Jean Charest, Gigi Dawe, Susan McGeachie, and Anton Tabuns talked about legislation and attitudinal changes affecting the roles of directors.

> *“More and more, stakeholders are becoming important to the future success or future financial performance of companies. So, if shareholder interests are at odds with stakeholder interests (e.g., those of a community group that has access- or land rights), the company might, in the short term, focus on that area.”*
>
> *Panelist Susan McGeachie*

New Canadian changes to **legislation** (Table 3) require directors, as part of their fiduciary duty, to consider all stakeholders -- not just shareholders -- in decision making. That said, the question of which stakeholder should be considered above others or what is the best decision in the best interest of the corporation “…requires balance, weighing, situational context, and for boards to use their judgment.”[120] There is no primacy of any one stakeholder or shareholders over another -- and there never was -- except acting in the best interest of the corporation. Directors must simply get away from the narrow interpretation of creating shareholder value above all else.[121]

Sonia Struthers

As with the general population, the recognition of climate issues by directors has grown, particularly over the last five years.[122] Boards of directors see the need to consider climate-related risks and opportunities and their possible effects on the organization,[123] and TCFD recommendations include describing how boards are overseeing those.[124] Canadian changes to **guidance** (Table 3) require directors, as part of their fiduciary duty, to consider climate risk in decision making and to consider the use of SASB and the TCFD framework.

Susan McGeachie

Gigi Dawe

Anton Tabuns

That said, the limited time directors have to consider immediate pressing issues, let alone long-term strategy, makes adding climate-related risks an additional challenge.[125] That challenge is a ***duty***, however, according to legal opinion sought by the Canada Climate Law Initiative:[126]

Gigi Dawe

> *"…The obligation of directors to consider the implications of climate change risk is grounded in the duties each director owes to the corporation…In managing or overseeing the management of risk, directors must meet the objective standard of what a reasonably prudent person would do in comparable circumstances…[D]irectors must put aside their own preconceptions about the reality or imminence of climate change risk. They may not demure to management and simply wait for presentations to be made to them. Directors must put climate change on the board agenda. They must require reports and recommendations from management and external sources as necessary, and be satisfied that the corporation is addressing climate change risk appropriately."*[127]

Table 3: Examples of Canadian Legislation and Guidance[128]

Source: Derived from presentations by Panelists Sonia Struthers, Jean Charest

LEGISLATION:
Canadian Business Corporations Act (CBCA). Many companies in Canada are incorporated under this federal law. Until 2019, the fiduciary duty of directors and officers was to act in the best interest of the corporation – traditionally, and narrowly -- interpreted to mean the best interest of the shareholders. The legislation was modified in 2019 and 2020. ▪ 2019. The newly defined fiduciary duty of directors and officers is to act in best interests of corporation for stakeholders: shareholders, employees, retirees and pensioners, creditors, customers, governments, the environment, and the long-term interests of the corporation. The new definition is an explicit codification of existing Supreme Court of Canada case law. So now, in exercising their fiduciary duty, directors and officers must take into consideration stakeholders and the long-term interests of the corporation. ▪ 2020. Public issuers [no matter what the exchange], not private corporations, must disclose numbers, targets, and policies (including participation on the board and as executive officers) for women, visible minorities, aboriginals and people with disability.
Pension Benefits Act (Ontario) requires Ontario pension plans to explain in their statements of investment policies and procedures (SIPP) how ESG factors are used in investment decisions and, if ESG factors are not used, why not. McCarthy-Tétrault has found that most pension plans have adopted an ESG policy, which required a re-examination of their portfolios. De-selection of companies (public and private) without sufficient disclosure has led to a shift in investing patterns.
GUIDANCE
Canadian Securities Administrators (CSA) Staff Notice 51-358, *Reporting of Climate Change-related Risks*[129]provides detailed guidance to boards on disclosure in respect to climate change risks.
Canadian Coalition for Good Governance (CCGG).[130] The CCGG includes most of the largest institutional investors in Canada.

"Integrating E&S into corporate governance considerations is part of the fiduciary duty of investors."[131]

Principle 7[132] of its **voluntary** *Stewardship Principles*, developed in consultation with members, says:

> *"Institutional investors should focus on promoting the creation of **long-term sustainable value**…Institutional investors should make sure they understand the risk and opportunities associated with material sustainability factors, including **environmental, social and governance issues**, and integrate them into their investment and stewardship activities. Institutional investors also should be aware of systemic risks that can affect the companies in which they invest."* [Emphasis added.]

The CCGG:

- designed the principles *"…to complement, rather than supersede or conflict with, the stewardship principles or codes of other countries or other investor organizations that institutional investors may choose to follow."* [133]
- suggests the use of the **TCFD disclosure framework**. [Emphasis added.]

Canada Pension Plan Investment Board's updated policy on Sustainable Investing on July 23, 2020 indicates preference for the Sustainability Accounting Standards Board (**SASB**) and the **TCFD** standards and reinforces the ESG role in long-term value creation.[134] [Emphasis added.]

Consolidation of Reporting Frameworks

The need to reduce the number of reporting frameworks in order to increase comparability, and to reduce complexity, competition, cost, and confusion, was addressed by Panelists Daniel Hicks, Linda Coady, and Naomi Soderstrom.

> *"Investors are driving reporting frameworks to speak the same language. Why? Investors are demanding some level of standardization."* *Panelist Daniel Hicks*

Linda Coady
Naomi Soderstrom

Alignment of the five leading sustainability and integrated reporting organizations and their commitment to work together to develop a comprehensive reporting system is hopeful news that may, eventually, reduce the administrative burden of disclosure.[135] [136]

Mandatory versus Voluntary Disclosure

Panelists Jody Grewal, Stefan Reichelstein, and Naomi Soderstrom reported on how mandatory reporting can force positive change.

Jody Grewal
Stefan Reichelstein

U.K. public companies were mandated in 2013 to disclose GHG emissions in their annual reports. Approximately half had voluntarily disclosed prior to the mandate.[137] For a subset of those companies that were also operating in Europe, their emissions data were already public. The requirement for additional transparency in the U.K. led to a further reduction in emissions compared to companies not subject to the regulation.[138] So, "[d]isclosure regulation can be an effective policy tool to affect ESG outcomes even among already-disclosing firms."[139] The companies that further reduced their emissions did not show changes in profit margins, so the conclusion is that the regulation produced real effects with no significant cost.[140] Other research has shown that "making disclosure mandatory changes the way that decision-makers use the disclosed information."[141]

Technology and the Changing Reporting Environment

Panelist Daniel Hicks focussed on the role of technology and media in sustainability/ESG reporting.

Daniel Hicks

Technology is driving change. The whole nature of communicating with stakeholders now has fundamentally changed: it is no longer passive, but **interactive**, thanks to social media. That means that corporations are rethinking what it means to engage with stakeholders across ESG, because millennials are used to **responding** -- and expect **interaction** -- because of the phone in their hands.[142]

Daniel Hicks

Every company has become a media company, because this interactive environment has produced direct communication between consumers and providers of information and has cut out the middle (traditional media: newspapers and television). This has ramifications around **accountability**: companies must start talking about how their financial- and non-financial metrics contribute to the overall value they produce, particularly in terms of social equity, diversity, and inclusion. Being ***financially*** healthy is not enough: a company must show it is ***socially*** healthy --- ***in real time*** – when issues come across social media.[143]

ESG: Roles for Accountants

Every panelist identified roles for accountants in "ESG space," collected here under four sections:

- In the Middle
- In Measurement
- In Monitoring
- In Reporting

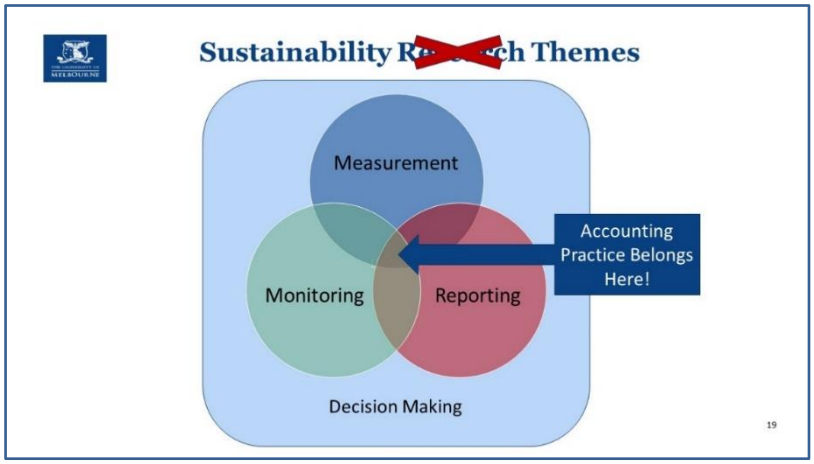
In the Middle

The potential role for accountants? Right in the **middle** (Figure 6). That middle position is the convergence zone between measurement, monitoring, and reporting.[144]

Figure 6: The Role for Accountants in Sustainability Space[145]
Source: Panelist Naomi Soderstrom

The middle also has **advisory-role potential**. It is the zone between climate/energy and business. Accountants could be the **translators** between these areas.[146]

Jean Charest
Linda Coady
Gigi Dawe
Naomi Soderstrom



- For directors, fiduciary duty is important and not optional. Directors know they must move forward on climate impacts and integrate ESG issues into corporate planning. So, advisors (e.g., accountants) could add value through data quality, assurance, and insights for decision making.[147]
- For development of broad-reaching ESG standards, momentum has increased because of the TCFD. Although accountants may be too late to provide leadership,[148] [149] the coalition of leading standards/framework organizations recognizes the need for advice from the IFRS[150] to add legitimacy to their reporting system:

> *"Our standards and frameworks act as a starting point for the technical content, while the* ***IFRS Foundation*** *could provide an appropriate governance architecture to achieve global acceptance. Integration with the IFRS Foundation's governance and oversight could deliver internationally-accepted institutional arrangements for sustainability disclosures relevant for the capital markets, ensuring robust governance, rigorous due process and independent standard-setting, within the context of accountability to public authorities who foster outcomes that are in the public interest. This public/private model has proven to be effective in leading to general acceptance and widespread adoption of financial accounting standards."*[151] [Emphasis added.]
>
> *CDP, CDSB, GRI, IIRC, and SASB, September 2020*

In Measurement

Naomi Soderstrom
Rosemary McGuire

Rob McLean

Measurement is where accountants excel.[152] Accountants can apply measurement fundamentals intrinsic to the traditional transaction-centric accounting paradigm to other measurement categories, including metrics and ESG frameworks.

Measurement fundamentals are the principles that underlie valid measures (e.g., apples to apples; volume to volume, etc.). Measurement approaches that violate these principles can be misleading, incomplete, inaccurate, and lead to conclusions and decisions that differ from those that would be reached based on valid and precise measures.

Panelist Rob McLean[153]

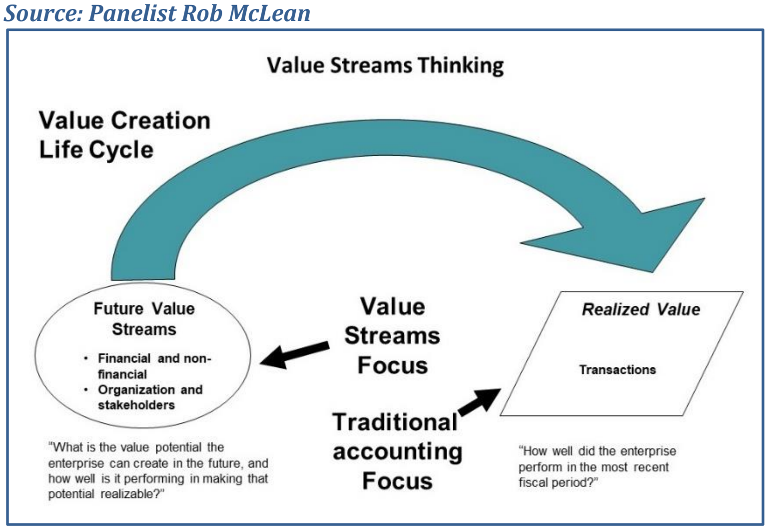
Traditional accounting focuses on measuring ***realized*** value. Now, accountants can contribute to estimating value ***potential*** in life-cycle terms.

For example, the development of a COVID vaccine has ***potential*** value; a developed vaccine has ***realized*** value.

How well is the company performing in making that potential realizable?

Accountants can help with "value streams thinking." [155] (Figure 7)

Figure 7: Accountants Can Help with Value Streams Thinking[154]
Source: Panelist Rob McLean



In Monitoring

Auditors have a huge role to play in the ESG area. Assurance of sustainability reports is more difficult than a financial report, just because of the diversity of things reported. The assurance function not only helps to guard against misleading reporting but facilitates improvement of reporting systems and help regulatory programs be more effective.[156] Accountants are needed to account, qualify, assure, and certify.[157]

Naomi Soderstrom
Daniel Hicks
Linda Coady

Rosemary McGuire

Could accountants close the gap between measurement and assurance by improving the quality and format of data?[158]

Elizabeth White

The IFC sees accountants as essential for auditing ESG factors and substantiating impact claims and data for its funded projects (e.g., water savings or emission reductions). Transparency is important to the IFC, and confirming that proxies do not take the place of real data is important in the fight against greenwashing.[159] (Figure 8)

Figure 8: Importance of Accounting to the IFC[160]
Source: Panelist Elizabeth White

In Reporting

Accountants could play leadership roles in forward-looking decisions related to value creation in their organizations. For example, all decisions involve choices among alternatives, and good decisions require good information. Decisions should be supported by measures that clarify the consequences of alternative decisions, at the highest level of precision practicable.[161]

Rob McLean

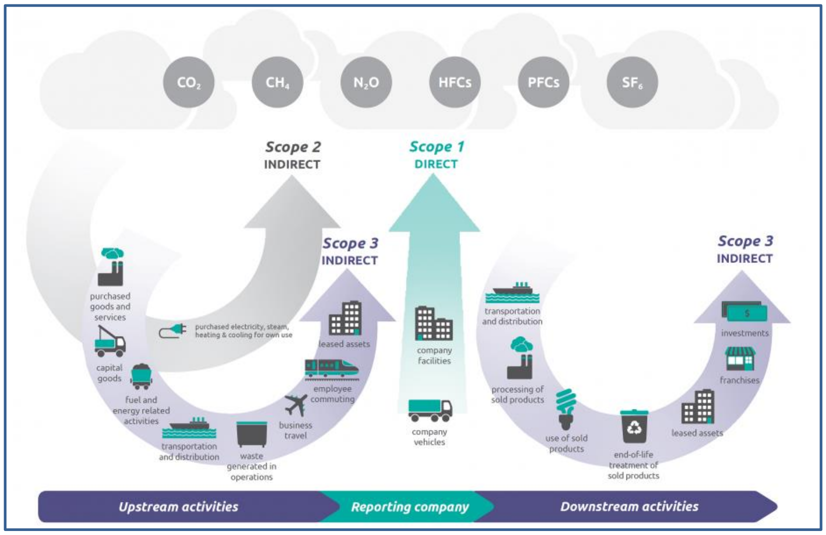
Sakis Kotsantonis

Jean Charest
Anton Tabuns
Linda Coady
Susan McGeachie

Harvard's Impact Weighted Financial Accounts Initiative requires a new generation of accounting statements.

On the path to net-zero, the TCFD recommends disclosure of greenhouse gas (GHG) emissions,[162] [163] which are called Scope 1, 2, and 3 (direct, indirect, and value chain) GHG emissions. (See Figure 9.) Accountants can play a role in this accounting. Accountants are needed for companies transitioning to net zero or developing transitional decarbonization technologies that require patient capital.[164]

Figure 9: Overview of GHG Protocol Scopes & Emissions Across the Value Chain[165 166]
Source: World Resources Institute.



CONCLUDING THOUGHTS

Some key messages from the conference can be summed up under the following group of headings.

Value and Values

> *"[A] company's value is increasingly reflected not just in its short-term financial performance, but also by intangible assets such as intellectual property, talent, brand and innovation, as well as impacts on society and the environment that are not fully captured by traditional financial statements."*
>
> *About the Embankment Project for Inclusive Capitalism (EPIC), 2018[167 168]*

Jean Charest

See also
Daniel Hicks

With more market value based on intangible assets, a company's social performance, particularly fair treatment of employees, will have direct impact on reputation, the ability to gain talent and win higher engagement from all stakeholders, especially employees.

Anthony Scilipoti
Shiva Rajgopal
Carson Block

Diversity and inclusion are moral and business imperatives. Diversity requires long-term vision: it takes years to have a pipeline of diverse candidates for leadership roles.[169]

If the value of a company, to many investors, will be in reflection of their **values**, not just alpha, this will require seeing a distant, not near investment horizon.

Long-termism versus Short-termism

> *"Instead of thinking about shareholder versus stakeholder capitalism, the better approach -- because it also is focussed on generating returns for shareholders and not degrading the profit generating capabilities of businesses -- is to think about shareholder returns in terms of the **10-year** shareholder or the **15-year** shareholder."*
>
> *Panelist Carson Block*

David Beatty
Jean Charest
Sonia Struthers

Long-termism -- getting away from quarterly-returns pressure and getting a handle on executive compensation -- is the key to working toward ESG goals.

For the environment, almost all-important is the need to change compensation plans so that companies:

Elizabeth White
Gigi Dawe

- increase their planning horizon
- identify and reduce their environmental impacts
- evaluate everything in terms of climate impact, and
- keep up the momentum to net-zero.

The TCFD asks "…organizations, where climate-related risks are material, to consider describing ***whether and how*** related performance metrics are incorporated into **remuneration policies.**"[170] [Emphasis added.]

> *You need to harness the power of good governance for institutional change: Governance takes centre stage as core driver of corporate change: "G" is the key to success in "E" and "S."*
>
> *Panelist Jean Charest*

Accountants' Roles

Measurement. Accountants excel at measurement and metrics. The qualitative nature of ESG factors makes them harder to measure and define. A better job of measuring ESG factors would facilitate the management of ESG, and that would influence the governance, risk-management, and remuneration within enterprises.

Len Brooks
Anthony Scilipoti
Rob McLean

Monitoring. Companies will be held accountable for their ESG performance. Accountants will be trusted for auditing and assurance because it is a traditional role. Trust in company disclosures is important, particularly for impact investing.[171]

Reporting and Advice. Accountants could add value through data quality, assurance, and insights for decision making.[172] Accountants have a role in the development of ESG reporting standards through the IFRS and the coalition of five sustainability and integrated reporting organizations.

Moving Beyond COVID. The conference began with a socio-economic context for ESG measures and an overview. Though we looked at E, S, and G separately at first, we saw that they are inextricably linked, with "E" and climate-related risks the imperative.

Companies with a long-term view will have a better chance of moving beyond COVID (Table 4).

Mark Carney warns,[174] however, that we can't self-isolate from climate. Climate change, "…from a human mortality perspective…will be the equivalent of a coronavirus crisis every year from the middle of this century, and every year, not just a one-off event. So, it is an issue that needs to be addressed now.

The power of money will ultimately play the biggest role in combating climate change.

Table 4:Think Long-Term to Move Beyond COVID

Think Long-Term to Move Beyond COVID…

Panelist David Beatty[173]

- "So many companies follow the Wall Street time horizon that now, in a time of crisis, they cut staff, close factories, exit entire businesses and try to preserve what precious net cash flow they have … and beg to their lenders for relief…
- "…[T]he creation of long-term, sustainable, differentiated and competitive advantage can be derived only with a strategic time horizon of five years and more…
- Companies with a long-term view support their people, partners and industry ecosystem. They win loyalty; they gain talent.
- The pandemic "…crisis can be used to dramatically shift the strategic horizons of your company to the longer term and in doing so help to shift free enterprise and publicly traded companies back to a sense of long termism."

The new financial system, spurred by the TCFD, will give investors, big or small, the information to choose how to invest.

Investors, with that information, "…can choose to be part of the solution, transitioning to net zero, or be part of the problem."

Accountants have an important role to play in that solution. Let's get involved.

With great thanks again to our panelists, supporters, directors, and audience,

Len Brooks

April 20, 2021