Vol. 2021, No. 1

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Q&A with an expert: Insights on ESG disclosure from the Sustainability Accounting Standards Board

By *Dimensions* staff

Under the administration of President Biden, the SEC will probably consider requiring disclosures in several environmental, social, and governance (ESG) areas. Public companies in the United States may have to disclose data on specific climate-change risks, which are currently reported only voluntarily and often outside SEC filings.

The Sustainability Accounting Standards Board (SASB) has taken a lead role in setting standards for voluntary ESG disclosure. *Dimensions* asked Madhu Mathew, SASB's Director of Technology, for insights into SASB's standards, its promotion of structured data and XBRL tagging, and its role after the SEC mandates more specific ESG disclosures.

What is meant by "sustainability" and "ESG disclosures"? Are they the same?

The concept of sustainability (or, more specifically, sustainable development) is defined in the Brundtland Report (*Our Common Future*) as "development that meets the needs of the present without compromising the ability of future generations to meet their own needs." In the context of companies, we can think of sustainable performance as firm operations that maintain or enhance firm value today without compromising the ability of the firm to create value in the future. SASB's use of the term "sustainability" refers to activities that maintain or enhance the ability of the company to create enterprise value over the long term.

Sustainability issues can be related to the environment (E), society (S), and corporate governance (G). In that sense, the two terms are similar, but sustainability is used in a broader sense. The capital markets tend to use the term "ESG" as it provides a certain specificity to the issues that they are referring to in the context of long-term enterprise value creation.

What is SASB, and what is its role related to these disclosures?

SASB is a nonprofit standard-setting organization. We establish industry-specific disclosure standards across financially material environmental, social, and governance topics. We envision an investment universe where a shared understanding of companies' sustainability performance enables companies and investors to make informed decisions that drive improved sustainability outcomes and thereby lead to improved long-term value creation.

What type of disclosure standards does SASB suggest, and why are they industry-specific? Are they similar to accounting standards?

Sustainability issues affect industries differently. For example, a company in the insurance industry might have very low Scope 1 greenhouse gas emissions because its operations are mostly situated within office buildings. But if the company has insured assets in areas prone to extreme weather events, then its risk exposure to climate change may be very high. That is precisely why SASB's Insurance Standard has a disclosure metric (FN-IN-450a.1) related to environmental risk exposure.

Market value typically differs from book value, in part because traditional financial statements do not necessarily capture all the factors that contribute to a company's long-term ability to create value. Much of this "value gap" is attributable to or can be significantly impaired by the management or mismanagement of environmental, social, and human capitals as well as corporate governance. Therefore, corporate disclosure must extend beyond financial statements to facilitate the measurement and reporting of sustainability information that will enhance a decisionmaker's understanding of all material risks and opportunities.

Like financial accounting, sustainability accounting has both confirmatory and predictive value, so it can be used to evaluate past performance and be used for future planning and decision support. As a complement to financial accounting, it provides a more complete view of a company's performance on material factors likely to affect its ability to create long-term value.

Financial accounting addresses some elements of sustainability performance. However, financial accounting is intended, for the most part, to reflect an entity's current financial condition and financial performance. Assessing the financial impact of sustainability issues is inherently limited by the absence of proper valuation techniques and/or adequate market pricing. While environmental, human, and social capitals can be understood conceptually as economic assets and liabilities, the lack of comparable data makes accounting for these sustainability factors challenging—a deficiency that the SASB Standards are built to address.

How does SASB determine what is material information that should be disclosed?

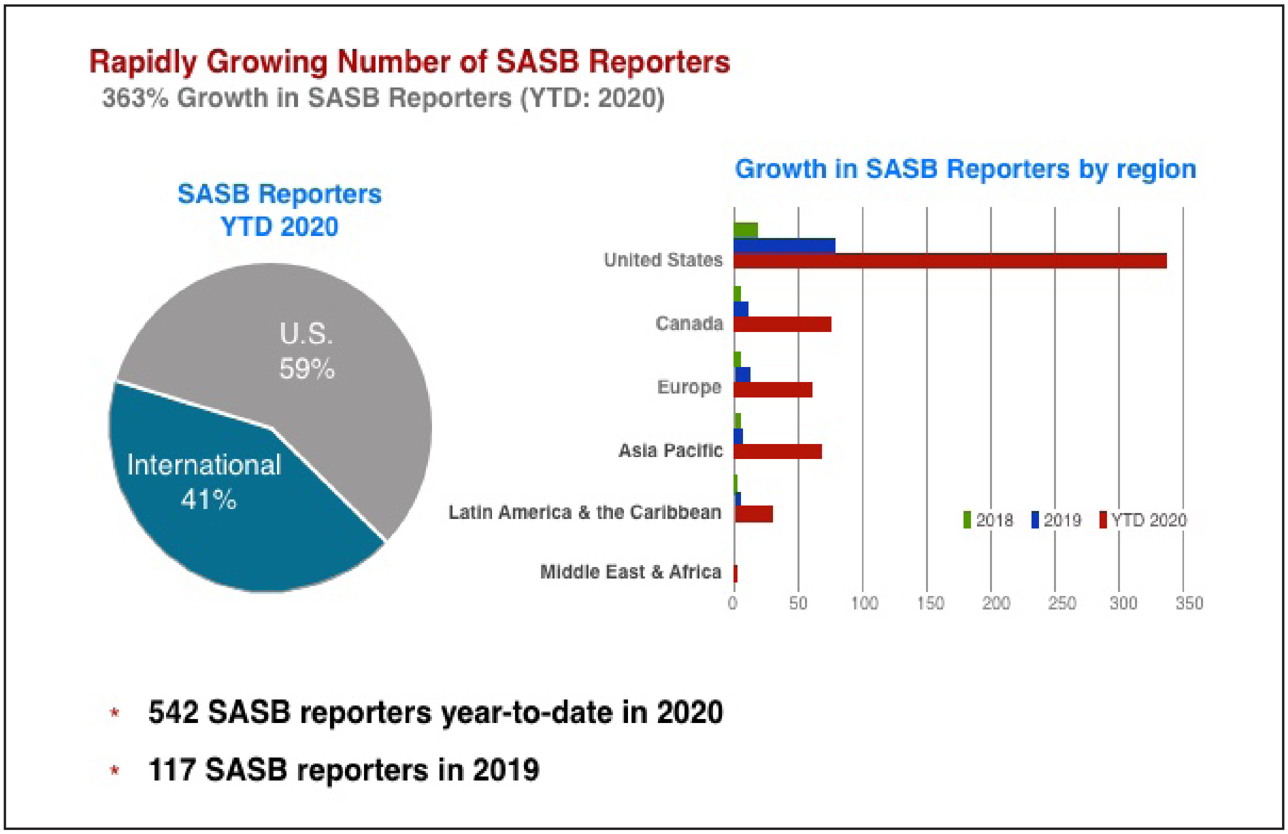
The SASB Standards address the sustainability topics that are reasonably likely to have material impacts on the financial condition, operating performance, or cost of capital of companies in an industry. SASB recognizes that each company is responsible for determining what information is material and what information should be included in its disclosures. In identifying sustainability topics that are reasonably likely to have material impacts, SASB conducts extensive research to identify evidence of financial impact associated with sustainability issues, and evidence of investor interest in those impacts.

CORPORATE DISCLOSURE MUST EXTEND BEYOND FINANCIAL STATEMENTS TO FACILITATE MEASURING AND REPORTING SUSTAINABILITY INFORMATION TO ENHANCE A DECISIONMAKER'S UNDERSTANDING OF ALL MATERIAL RISKS AND OPPORTUNITIES

For each disclosure topic identified in an industry, SASB selects or develops decision-useful accounting metrics to account for company performance on the topic. Accounting metrics address sustainability impacts, as well as opportunities for innovation. Taken together, they characterize a company's positioning with respect to sustainability issues and the potential for long-term value creation.

Are the SASB disclosure standards voluntary or mandatory for issuers (i.e., companies)?

SASB-based disclosures are voluntary. However, several regulatory jurisdictions have either recommended or are in the process of recommending the use of SASB Standards for disclosing financially material ESG information. Investors see the value in the standards and have recommended and encouraged companies to disclose using them. As a result, we are seeing rapid growth in voluntary SASB-based reporting, with 542 reporters in 2020. The following graph provides more details about the growth.



How do the SASB Standards further comparability in disclosures among companies in different industries?

Companies operating in the same industry are likely to have similar business models and, therefore, similar sustainability risks and opportunities. As a result, SASB develops sustainability disclosure standards at the industry level, focusing on issues that are closely tied to resource use, sustainability impacts, business models, regulation, and other factors at play in the industry. Industry specificity results in metrics that are comparable, as it allows users to identify which companies have similar versus different performance in an industry on a particular sustainability topic.

The SASB Standards also include activity metrics, which quantify the scale of a company's business and are intended for use in conjunction with sustainability accounting metrics to normalize data and facilitate comparison.

Your question is about comparing disclosures among companies in different industries. The SASB Standards are not really meant for such cross-industry comparison. While issues like climate change and issues related to human capital cut across industries, they manifest differently from one industry to another. So, an industry-specific approach tends to be more useful from a risk-management perspective.

Are the sustainability reports separate or integrated as part of another corporate or SEC report?

We are seeing SASB disclosures occurring in many different reports. The majority of the disclosures occur first in corporate sustainability reports and/or independent reports called ESG Release or SASB Report. But we are also seeing them in integrated reports and annual reports as well as regulatory filings. (An integrated report is one based on the principles developed by IIRC.)

Do disclosures on sustainability correlate with a company's financial health?

Research supports that idea. In *Corporate Sustainability: First Evidence on Materiality* by Mozaffar Khan, George Serafeim, and Aaron Yoon, the authors find that firms with good ratings on the disclosure topics identified in the SASB Standards significantly outperform firms with poor ratings on these issues. In contrast, firms with good ratings on "immaterial" sustainability issues (e.g., ESG issues not identified by SASB for a given industry) do not significantly outperform firms with poor ratings on the same issues. Lastly, they find that, with all else being equal, firms scoring at the top quintile on the material issues have higher future return-on-sales growth.

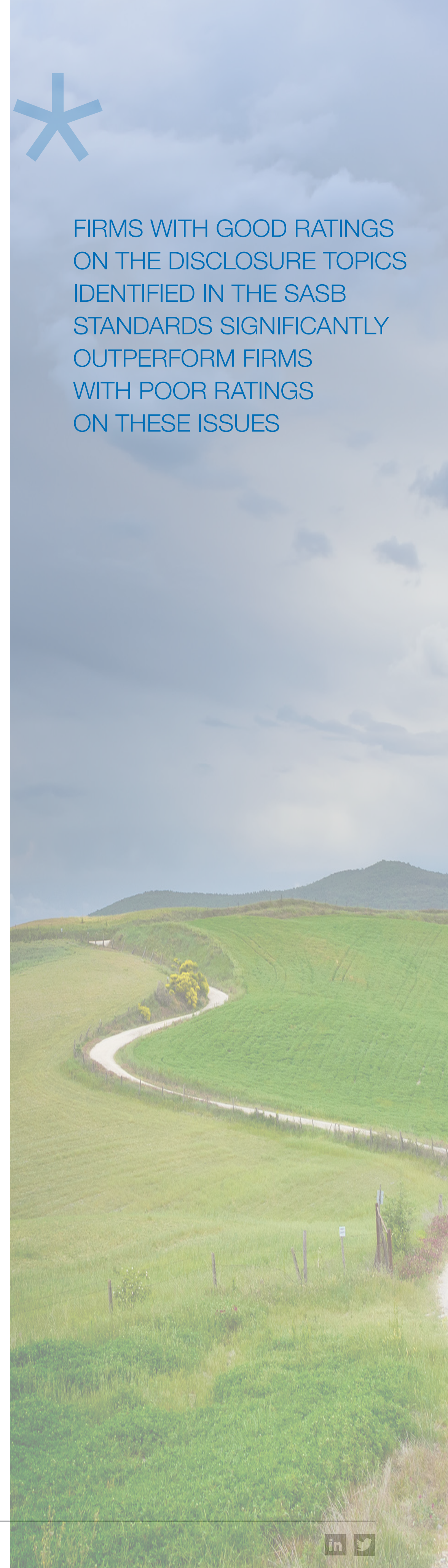
Several research papers on SASB have been published and are available on our website. Readers will find them very interesting.

One other interesting thing I would like to mention is that the very idea of SASB was first introduced by the Initiative for Responsible Investment at Harvard University in a white paper co-authored by our founder, Jean Rogers: *From Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues*.

Does the SEC also have these types of specific disclosures on ESG?

No, the SEC does not have these types of specific disclosures. The SEC recently issued its long-awaited amendments to Regulation S-K. The rulemaking includes a new requirement that public companies disclose information about "human capital resources" in these filings. The final rule is principles-based rather than prescriptive.

SASB supports a principles-based approach, and we submitted a comment letter to that effect. But we also stated that, in order for a principles-based rule to result in consistent and comparable company-to-company disclosures, the SEC would need to refer to a disclosure framework or standards; hence we recommended that the SEC either strongly urge or require companies to make disclosures pursuant to an ESG framework that—like SASB's—has been developed through due process, is based on financial materiality, and is intended to meet the informational needs of investors.



Does SASB anticipate that the SEC will propose and adopt more specific sustainability/ESG reporting requirements? What does SASB anticipate will be the top ESG areas for SEC rulemaking?

We have continued to stay engaged with the SEC. In our public comment to the SEC on Regulation S-K, we requested that the SEC consider referring to the SASB Standards as a useful tool for making consistent, comparable, reliable sustainability disclosures in regulatory filings. There does appear to be some urgency at the Commission to enhance disclosure to investors regarding climate risk, and it seems more likely that the SEC may prioritize that work under the incoming administration.

If the SEC does require more specific ESG disclosures, such as on climate change, how do the SASB Standards fit into them?

Climate change does not affect every industry in the same way. The SASB Standards enable companies to disclose climate-change-related data that helps investors better understand how companies are performing in regard to the climate-change-related impacts and drivers most closely related to their business model. For example, in the automobiles industry, it is fuel economy; and in the insurance industry, it is risk exposure to physical effects of climate change.

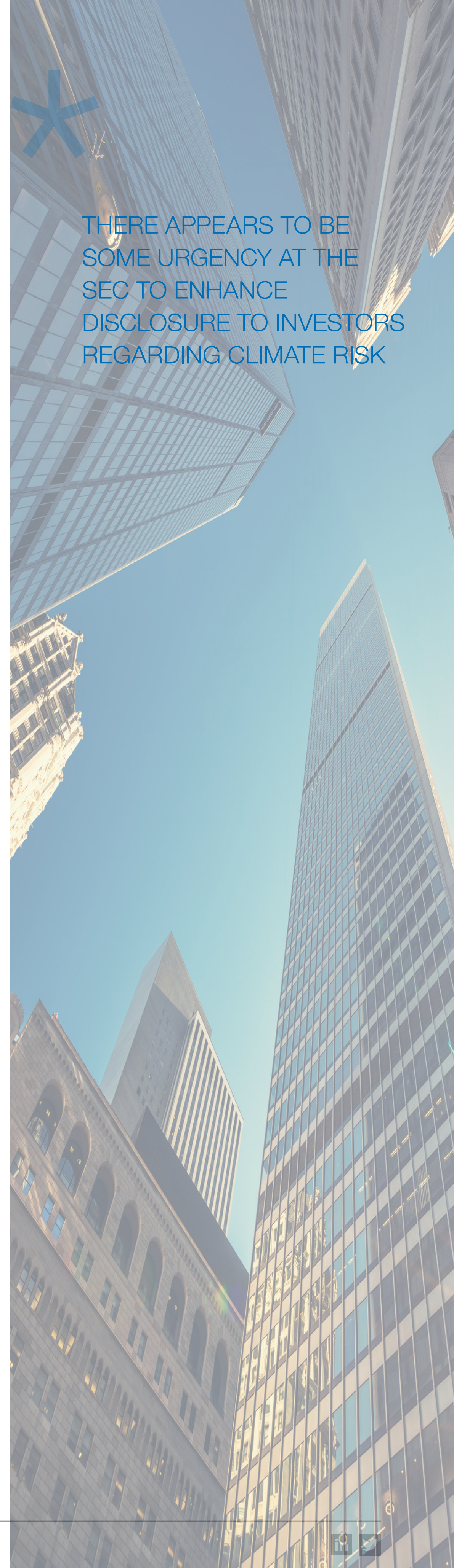
Are there regulatory bodies in other countries and stock exchanges using the SASB disclosure standards? How do the SASB Standards work together with the local requirements?

Yes, there are several regulatory bodies across the world that are either considering recommending or have already recommended using the SASB Standards. In Japan, the Philippines, and the UK, regulatory authorities have noted that SASB Standards can be used. In Canada, the European Union, Taiwan, and New Zealand, consultations are underway. There are 27 stock exchanges around the world that recommend the use of SASB Standards.

Certain local jurisdictions may require additional disclosures for the achievement of specific policy objectives. SASB recognizes the importance of jurisdiction-level overlays, which can ensure that global standards from SASB are complemented by any additional disclosure requirements needed for achievement of such specific policy objectives.

The SASB created its own taxonomy for XBRL. Why is SASB now promoting structured data and XBRL tagging for its disclosure standards? What does this show about the acceptance and demand for this type of structured disclosure?

There is growing demand from investors for SASB disclosures. Now there is growing supply of SASB disclosures from companies. XBRL is a mechanism by which disclosed data can be distributed efficiently, accurately, and in a timely manner. By making SASB-aligned data readily and widely available, the capital allocation and investment decision can be made based on relevant and necessary ESG information. That is fundamental to the SASB mission.



THERE APPEARS TO BE SOME URGENCY AT THE SEC TO ENHANCE DISCLOSURE TO INVESTORS REGARDING CLIMATE RISK

Why is making sustainability disclosures available in a structured format (e.g., XBRL) better for issuers and investors?

When disclosures are available in a structured format, it becomes easy to collect and aggregate the data. It makes complex AI and other human-based collection of data unnecessary. It also ensures that data being collected is accurate. The information supply chain becomes more efficient, and the time between when a company discloses and when that information becomes available within investor analytics tools and terminals will be greatly reduced. Issuers benefit because the information gets into the hands of the investor quickly and accurately. Investors can then use this information with greater confidence in making decisions.

Are SASB's XBRL standards similar to the SEC approach to XBRL? If the SEC adopts mandatory ESG disclosure and requires XBRL tagging as part of it, how would SASB's structured-data standards work with it? Would they interact and co-mingle together in some way or be separate?

SASB's XBRL taxonomy is built very similarly to how GAAP taxonomy is built. Our hope is that the SEC approves the SASB taxonomy and allows filers to use the SASB taxonomy to tag SASB disclosures.

Would preparing SASB disclosures and XBRL tagging change the process of preparing financial reports for issuers?

Our recommendation is that preparing SASB disclosures should follow essentially the same process that companies currently use for financial reporting. Given the financial materiality of the information, it should have a robust review and verification process.

We are working with leading filing-software providers to integrate SASB XBRL taxonomy into their platforms. Once integrated, the goal is to make SASB reporting as seamless as possible to the existing process.

Why did SASB and the International Integrated Reporting Council (IIRC) decide to merge into a new organization, to be called the Value Reporting Foundation? Will this lead to any changes in the current SASB disclosure standards?

The Value Reporting Foundation will merge SASB and IIRC into a credible, international organization that maintains the Integrated Reporting Framework, advocates integrated thinking, and sets sustainability disclosure standards for enterprise value creation. The merger directly responds to calls from global investors and corporations to simplify the corporate reporting landscape, providing the market with a clear solution for communicating about the drivers of enterprise value.

Barry Melancon, chair of the IIRC Board, articulated it best: "The <IR> Framework and the SASB Standards are complementary. Integrated reporting describes all relevant value creation topics and the approach to integrating them in corporate thought and reporting. SASB provides the precise definitions of the data that should be reported for these topics in each industry. Organizations globally already use both to communicate effectively with investors about how sustainability issues are connected to long-term enterprise value, with these endeavors ultimately benefitting other key stakeholders. Under the Value Reporting Foundation, we will link the concepts between the <IR> Framework and SASB Standards even further."

Note: The views expressed here are Mr. Mathew's and not necessarily those of SASB.

Best efforts cannot always avoid FD violations

Abstracted from: *Regulation FD Turns 20: Our Take*
The Corporate Counsel
Vol. 45, No. 5, Pgs. 12-17

Regulation FD grew out of inability to protect retail investors. Regulation FD turned 20 in 2020. The SEC might never have adopted Regulation FD, *The Corporate Counsel* notes, except for the simultaneous trends in the 1990s that highlighted the regulators' inability to protect individual investors from public companies' overly close ties to securities analysts. Many investors, including day traders, came to favor direct trading over employer-sponsored retirement plans and mutual funds. The Internet provided easy access to market data, online trading became inexpensive, and investors feared missing out on investing in a steady stream of IPOs. They soon discovered that they faced two difficulties: IPOs did not allocate shares to individual investors, and companies practiced selective disclosure. The available market data, while more plentiful than in pre-internet days, was still far less than what companies were giving to analysts and the banks employing analysts.

Whether selectivity is intentional or not. Supreme Court decisions in the 1980s—such as *Chiarella* and *Dirks*—prevented the SEC from attacking selective disclosure by punishing insider trading (which therefore thrived). So the SEC adopted Regulation FD, based on its power under Section 13(a) of the 1934 Act to compel full and fair disclosure. FD's trigger is the disclosure by a public company or its agents of material nonpublic information to analysts, institutional investors, other stock-market professionals, or specified holders of company securities, absent an exemption. The company must then publicly disclose that information in a wide-ranging, all-inclusive manner. Intentional selective disclosure requires simultaneous disclosure, the article explains, while unintentional selective disclosure requires disclosure promptly thereafter. The company may use Form 8-K; a press release sent to a broadly disseminated news service or wire service; a properly noticed, publicly accessible webcast or teleconference; or, under specified conditions, its website or social-media accounts. Regulation FD has succeeded in eliminating selective disclosure by making remediation nearly impossible when the selectivity is intentional, as it almost always is.

Little enforcement, but pandemic raises the risk. The SEC has never aggressively administered or enforced Regulation FD. There were only five enforcement actions—every one of which was settled—in the regulation's first four years, and few since then. The SEC has offered advice on using company websites or social media to comply with Regulation FD, but companies find the advice antiquated, so an overwhelming majority still depend on time-tested means of compliance: press releases, 8-Ks, or both. Companies need more help from the SEC than ever during the COVID-19 pandemic. Violations during the pandemic are likelier, the article warns, since wildly fluctuating stock prices and general economic uncertainty push analysts and shareholders to demand information on management's comfort with previous earnings guidance, business performance, steps taken to maintain liquidity, and company prospects.

Remediating and fine-tuning compliance. Companies' best efforts cannot always avoid Regulation FD violations, concludes *The Corporate Counsel.* Officers often meet privately with analysts or investors, who persuade them to elaborate on publicly disclosed information. When this happens, corporate counsel needs to take remediation steps. First, decide if the selective disclosure was unintentional. If so, file an 8-K immediately. If not, as is generally the case, decide if the new information was material and nonpublic. This is generally not the case, but if so, decide whether to self-report to the SEC, which might respond by forgoing an enforcement action. The SEC could also learn of a possible violation through its sophisticated technology, which detects unusual trading and dissemination of information to the markets, or from a whistleblower or a disgruntled analyst or investor. Companies should fine-tune their FD policies to stop the external release of all material nonpublic information by restricting who may speak publicly for the company; setting up a central information clearinghouse headed by a compliance officer; clearing all presentations to analysts or investors; suitably restricting social-media usage; and watching for abnormal trading, communications with analysts and investors, and market rumors.

Abstracted from ***The Corporate Counsel,*** published by CCRcorp, 7600 N. Capital of Texas Highway, Building B, Suite 120, Austin TX 78731. To subscribe, call (800) 737-1271; or visit *www.thecorporatecounsel.net*.

RECENT DEVELOPMENTS

SEC Commissioner calls for XBRL tagging beyond financial statements

By *Dimensions* staff

Now that XBRL use in financial statements is well established among filers, capital markets, and regulators alike, what comes next for structured data in SEC reporting? Hints emerged during *The Promise of Structured Data: True Modernization of Disclosure Effectiveness*, a recent speech by SEC Commissioner Allison Herren Lee delivered to the XBRL US Investor Forum 2020, *Ready for Anything—Using Data in Perilous Times*.

Commissioner Lee states that the SEC's ongoing spate of rulemaking to modernize disclosure should now address the application of structured data requirements beyond financial statements: "As we continue to modernize, we should consider obvious places where structuring could be relatively simple and would provide significant transparency benefits." She discusses the potential for XBRL tagging of data in the MD&A section, earnings releases, and proxy-voting disclosures, and she points out the benefits of XBRL for new types of mandatory SEC disclosures: climate-change risks and other environmental, social, and governance (ESG) issues, which increasingly influence investors' decisions.

Beyond financial statements: proxy voting, MD&A, earnings releases, identifiers

Commissioner Lee identifies several key areas ripe for the SEC to expand the use of structured data. One is the disclosure of proxy-voting data on Form N-PX. Under the Dodd-Frank Act, the SEC proposed a rule in 2010 that would require institutional investment managers to report their proxy votes on executive compensation, a long list of yes or no votes formatted to tag easily. This "say on pay" rule has, a decade later, still not been finalized.

What data would be included in an XBRL mandate for proxy-voting disclosure? "The most basic information that an investor might want: how their money is being voted in corporate elections, and whether their shares are being voted in their best interest or in accordance with their instructions," explains the commissioner. "We could bring much greater clarity and transparency to investors regarding how their voting rights are being exercised with the simple expedient of finalizing this rule and adding a requirement, as discussed in the proposal, to tag the Form N-PX voting data."

Commissioner Lee also supports the expansion of structured data to the MD&A and earnings releases, noting "disclosures under MD&A may benefit from some simple block tagging that could greatly enhance comparability of certain relatively consistent types of information disclosed in MD&A. And earnings releases, particularly given their often market-moving nature, appear to be another well-suited candidate for tagging."

Financial identifiers, such as the Legal Entity Identifier (LEI) and the Unique Product Identifier (UPI), offer another avenue to enhancing usability (and would align the SEC with growing LEI adoption by other regulators internationally). "As the utility of the LEI increases and work on other identifiers progresses, the Commission should carefully consider adapting its regulations and forms to incorporate them," she suggests. "One advantage of these uniform identifiers is that they are open, not subject to commercial licensing, and freely available." A working group formed by XBRL International has published an LEI XBRL taxonomy, which, she notes, "can be used in XBRL applications to unambiguously identify companies. The potential to more easily link LEIs within regulatory reports facilitates both research and meeting regulatory requirements such as know your customer and anti-money laundering. Overall, this promises another means of enhancing the usability of data in the Commission's filings."

ESG disclosures and their structured reporting could "develop in tandem"

Notably, Commissioner Lee's speech looks ahead at new topics for required SEC disclosures and the related structured reporting of them. Specifically, she discusses the introduction of mandatory ESG disclosures. This initiative would be novel territory for the SEC. To date, the SEC's XBRL mandate has been focused on the types of financial disclosure that already existed in non-structured ways. The new ESG disclosures that the commissioner envisions would give the SEC the opportunity to develop disclosure requirements and their structured format at the same time. "Instead of an *ex post facto* application of structuring requirements, the two could develop in tandem."

She emphasizes that "climate and other ESG-related metrics are of ever-increasing importance to investors, surpassing even traditional financial statement metrics for many." Yet for the most part, ESG disclosure requirements remain neither required nor standardized, so "developing standardized climate and ESG disclosure requirements should be a top priority for the Commission. As we consider this, we should also consider how to make the data disclosed under such requirements as usable as possible, including through tagging requirements."

This subject is a topic of interest for Ms. Lee. In another recent speech, *Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation,* she envisioned corporate disclosure on major financial risks presented by climate change. Where should the SEC start? Her vision is clear: "Data. All policy should proceed from a foundation and clear-eyed analysis of accurate, reliable data." Next comes consistent standardized disclosure. "The SEC should work with market participants toward a disclosure regime specifically tailored to ensure that financial institutions produce standardized, comparable, and reliable disclosure of their exposure to climate risks," she concluded.

XBRL errors and needless extensions may warrant third-party audits

Commissioner Lee reiterates the SEC's longstanding emphasis on accurate XBRL tagging and error prevention. Research indicates that material errors in SEC-filing data, including mistakes in XBRL tagging, are likely to be especially problematic for investors in areas such as revenues, net income, and assets. In addition, the commissioner observes, overuse of custom XBRL tags continues to hinder comparability of financial disclosures.

To help improve XBRL quality, some observers suggest that auditors should also be responsible for checking XBRL tags. While the SEC has "specifically declined to require any auditor assurance related to XBRL or even transparency around any auditor involvement," Ms. Lee observes, it may be appropriate to "revisit the issue of third-party verification, including whether in an Inline environment, review of the tags should be part of the audit." *[Editor's Note: With President Biden's nomination of Gary Gensler to chair the SEC, these priorities may change.]*

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