GLOBAL INSIGHTS REPORT

Three Big Wake-Up Calls for Boards

A joint report by Datamaran and The Conference Board

Executive Summary

2020 was an eventful year on many counts. How have large public companies reacted to the year's events in their corporate reporting, and how can senior executives apply this knowledge in their responses to other systemic and external risks?

In this Global Insights Report, Datamaran and The Conference Board examine corporate reporting on three of the biggest ESG issues facing business today:

- Public health
- Climate change
- Diversity, equity & inclusion

We focus on some of the largest public companies from Europe and the United States, examining the S&P 500 and the S&P Europe 350.[1] The research is based on the level of emphasis corporations place on external risks, including ESG issues, in their financial reporting.[2]

Given the different regulatory regimes across the globe governing disclosure, as well as industry norms, the majority of disclosures in some markets continue to occur in nonfinancial reports, where companies may have greater latitude to include disclosure on health, environmental, and workforce matters.[3] Further, companies are applying a higher level of rigor and attention to ensure that the disclosures in nonfinancial reports are reliable.[4]

Disclosure in financial reports is a signal of the level of attention those issues receive in corporate risk management and overall governance processes, given the rigorous internal controls applied to reviewing information included in financial disclosures. Financial reporting illustrates to different stakeholders, including investors, regulators, and business partners, what risks and opportunities senior leaders are considering, planning for, and managing. This research identifies ESG issues that may merit more attention through formal risk management and governance processes. It takes into consideration

1 Datamaran is a software analytics platform that identifies and monitors external risks, including ESG. Its patented technology offers real-time insights into strategic, regulatory, and reputational risks—current and emerging. Datamaran has a collection of corporate reports (annual financial, annual sustainability/ESG, and SEC filings), hard laws, soft norms and policies, social media, online news, and custom sources. This publication features insights from corporate reports and regulatory initiatives.

2 On the applications of natural language processing (NLP) to the analysis of companies' ESG disclosure, see Martin Quesada Zaragoza, Lianet Sepúlveda Torres, and Jérôme Basdevant, *Translating Knowledge Representations with Monolingual Word Embeddings: The Case of a Thesaurus on Corporate Non-Financial Reporting*, Proceedings of the 6th International Workshop on Computational Terminology, European Language Resources Association, May 2020.

3 For example, in the US, the standard for disclosure in financial reports is "materiality" as defined by the US Supreme Court and SEC. This definition, based on what is likely to significantly affect the total mix of information a reasonable investor considers in making an investment decision, is narrower than other standards used in nonfinancial reports (e.g., in sustainability or corporate social responsibility reports). While maintaining this standard of materiality, the US SEC requires companies to include nonfinancial information and metrics in their regulatory filings, now notably including human capital management (the final rules are effective for the upcoming proxy season in 2021). Thus, in the US, it is common for financial reports to include a subset of nonfinancial information.

4 See: Thomas Singer, "Sustainability Assurance Practices," *Sustainability Matters*, The Conference Board, November 2019.

the disparate regulatory regimes when it comes to ESG disclosure and the fact that most US companies report on ESG topics outside their financial reports. But as ESG issues become increasingly relevant to investors, some of these issues are expected to make their way into more financial statements.[5]

Insights for What's Ahead

Now is the time for companies to examine whether their financial disclosures adequately acknowledge systemic risks. The events of 2020 brought risks related to climate change, social justice issues, and public health to the forefront of public consciousness. Corporate disclosures related to these risks generally increased over the last decade, but a significant number of large companies have not included these issues in their financial disclosures. For example:

- Almost 30 percent of the largest US companies and 10 percent of the largest European companies did not mention climate risks in their mainstream financial reporting.
- While virtually all European companies disclosed information related to fair and inclusive workplaces in their 2020 financial reporting, almost one-third of US companies did not.
- Public health risks were absent from most companies' risk disclosures in financial reports until the risk materialized with the emergence of COVID-19.

Risk disclosure needs to be specific to each company, but in light of intense investor interest, company boards and board committees should take a renewed look at their risk disclosures. Boards may also want to take a fresh look at which committees—beyond the audit committee—are involved in the process.

As more ESG issues are run through the financial disclosure process, companies may be increasingly expected to provide more specifics. While more companies are including ESG risks in their financial disclosures, many of these risks are described in broad terms. For example, climate risk disclosure has become more prominent but often does not include specific impacts, risks, and opportunities related to climate change. As more companies introduce public health risks and workplace diversity, equity & inclusion (DEI) issues into their disclosures—particularly given the US Securities and Exchange Commission's new rule on disclosure related to human capital management—companies should anticipate investors will be looking for more specifics.

5 In his keynote speech at the IFRS Foundation Virtual Conference in September, Chair of the International Accounting Standards Board Hans Hoogervorst emphasized that we can expect sustainability issues to be reflected in IFRS financial statements to a much greater extent than ever before. As sustainability issues become more pressing and governments become more ambitious in tackling them, their principle-based standards will require the financial statements to reflect these issues as they become more pervasive.

Materiality is dynamic: as companies react to the current crises, they should carefully consider what other relatively "dormant" risks might be around the corner. The COVID-19 pandemic suddenly elevated "public health risk" to the top of businesses' priorities. The impact of the pandemic on business has highlighted the need for companies to better prepare for other emerging risks. However, rather than increasing, the level of emphasis companies place on "business continuity" in their financial reports has dropped since the start of the pandemic. Given the importance of strong business continuity plans—made more evident by the current crises—the data suggest an opportunity to elevate disclosure of how companies are assessing and improving their business continuity plans. Going forward, companies may need to ensure their business continuity planning is more dynamic, as seemingly nonmaterial issues can quickly become material.[6]

From a practical standpoint, companies can prepare for other emerging risks by:

- Using real-time data to monitor the external risks landscape and stay on top of trends
- Taking a wide perspective of risks and opportunities that incorporates the views of investors, regulators, policymakers, employees, NGOs, the public, and the media
- Addressing risks that have been flagged as emerging but not identified as material

6 For a larger review of the concept of materiality and how it relates to governance and risk management processes, see Donato Calace, "Materiality: From Accounting to Sustainability and the SDGs," in: Walter Leal Filho et al. (eds), *Responsible Consumption and Production. Encyclopedia of the UN Sustainable Development Goals* (Springer, Cham: 2019).

"Getting executives and board members to look at ESG as an integrated business function is crucial. So much ESG data is traditionally based on past performance, and not forward looking. The more real-time you can get with your data, the better able you are to forecast where your company needs to go. That's the kind of information that stakeholders and decision makers want to see. And you can't be both timely and accurate in producing this information without the very latest technology."

Evan Harvey, Global Head of Sustainability, Nasdaq

"It's never been more important and urgent to focus on sustainability and the societal trends we see than right now. Faced with a global pandemic, climate change, and opportunities surrounding diversity, equity & inclusion, we all must continue to focus our efforts. Meaningful impact is driven by action more than intent, which is why Hexion completed a materiality assessment in 2020 as part of its ongoing sustainability strategic planning initiatives. With [a] data-driven approach to external risk analysis and input from key stakeholders, Hexion is now better positioned with a robust strategy to drive results and systematically monitor our success against ESG risks and opportunities."

Craig Rogerson, CEO, Hexion

Companies were largely unprepared for public health risks before they materialized

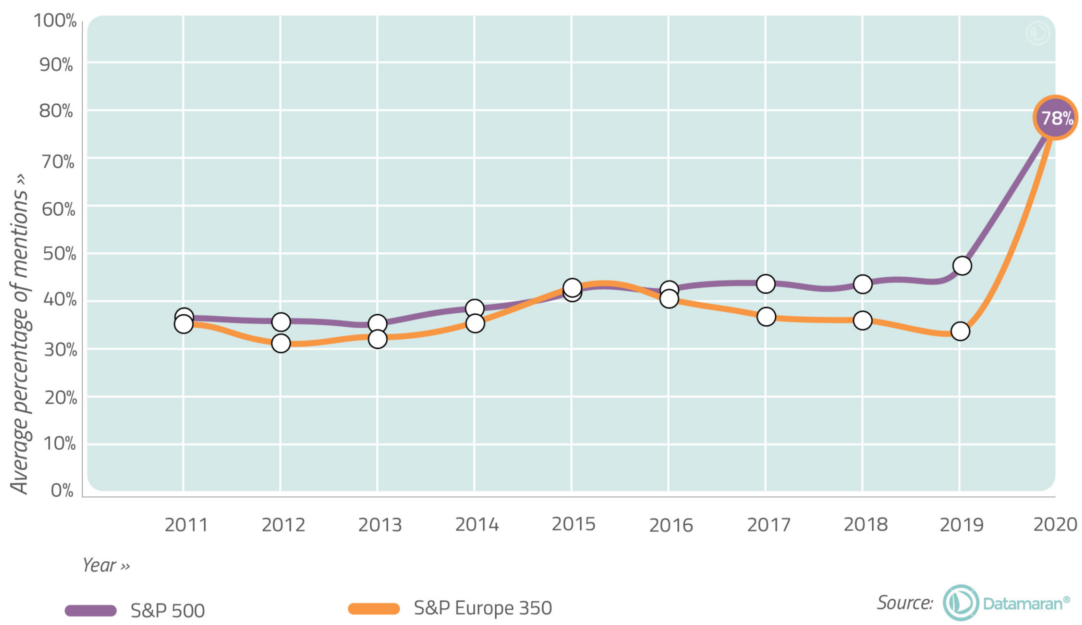
Examining the percentage of companies referencing public health risks in their financial reports reveals that pre-COVID-19, few companies acknowledged these risks in their disclosures. Almost half (45 percent) of the largest companies in the world did not mention the potential risk posed by public health in their 2019 financial disclosures (67 percent of European companies and 58 percent of US companies did not mention public health risks). These findings do not suggest companies and their boards were unaware of public health risks (such as pandemics), but they do indicate that for many companies, these risks did not make the cut as material.

Notably, 22 percent of companies still did not mention public health risks in their 2020 reports, given that April 2020 guidance from the SEC and the European Securities and Markets Authority strongly recommended that companies report on impacts (known or potential) to their investors. This lack of mention may be attributable to companies having issued their reports before the height of the pandemic. However, there were signs in early February that a growing epidemic could precipitate something much larger.

These findings emphasize the dynamic nature of materiality and how issues that are not deemed material can very quickly become material. Companies should address potential future risks that, while not immediately material, could quickly become so.

Chart 1

Percentage of companies mentioning ***public health risks*** *in their financial disclosures*

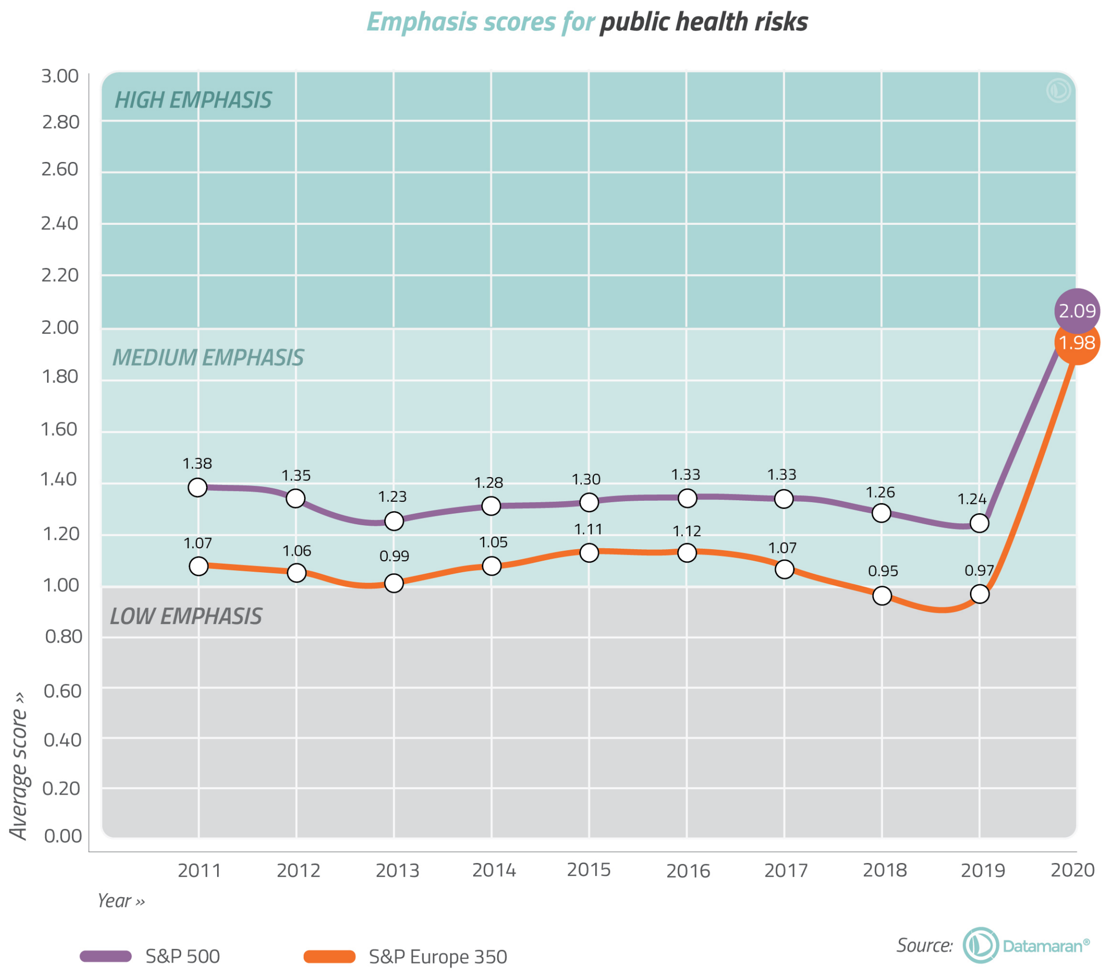


US companies lead a surge in emphasis of 'public health risk' in financial reporting

Disclosure of public health risks in companies' financial reports has remained at the low end of "medium" emphasis over the past decade, with US companies consistently placing a higher level of emphasis on it than their European peers.

Not surprisingly, in 2020 companies are placing significantly more emphasis on public health risks in their financial reporting. Among US companies, emphasis scores on public health risk surged by more than 40 percent, placing these risks in the "high" emphasis category for the first time. The same pattern is reflected in Europe, with emphasis on public health risk in financial reporting increasing by more than 50 percent compared to 2019.

Chart 2



Note: The level of emphasis is a Datamaran analysis based on natural language processing techniques, which enable computers to analyze, interpret, and categorize large amounts of unstructured data. Datamaran's patented technology ranks disclosures on external risk topics addressed in annual reports on a 3-point scale, with 3 representing the highest level of emphasis and 0 representing no mentions. This is derived from quantitative and qualitative information, including the number of associated narrative references to the topic, as well as where within the report bodies those references are made. The analysis offers a more comparable and accurate analysis of the level of attention a company or sector places on each topic.

The sudden increase in emphasis on public health risks, after a long period of relatively low emphasis on the topic, points to the dynamic nature of materiality.

> "What is financially immaterial today can quickly become material tomorrow."
>
> **World Economic Forum**, *Embracing the New Age of Materiality: Harnessing the Pace of Change in ESG*, March 2020.

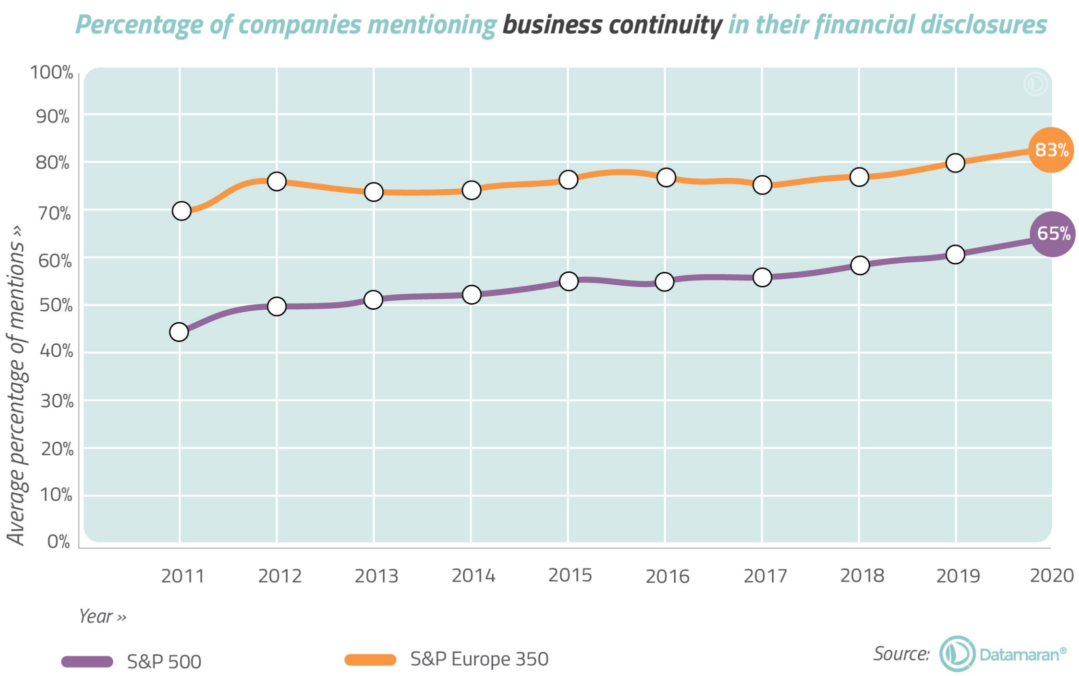
The COVID-19 pandemic has suddenly elevated public health risk to the top of businesses' priorities because the risk materialized. Companies should carefully consider what other relatively "dormant" risks might be around the corner. The challenge is to do so while avoiding having risk disclosures become an inventory of all possible black swan events.

Companies still have work to do in reassessing their risk management practices

While companies are now placing greater emphasis on public health risks in their financial disclosures, they have barely moved the needle on disclosure related to "business continuity,"[7] an indication that companies may be lagging in reassessing their resilience planning, risk management, and related governance practices.

Chart 3 examines the percentage of US and European companies that mentioned the topic of business continuity in their financial reporting over the past decade. The disclosure data show that European companies have been more consistently disclosing the topic of business continuity than their US counterparts.

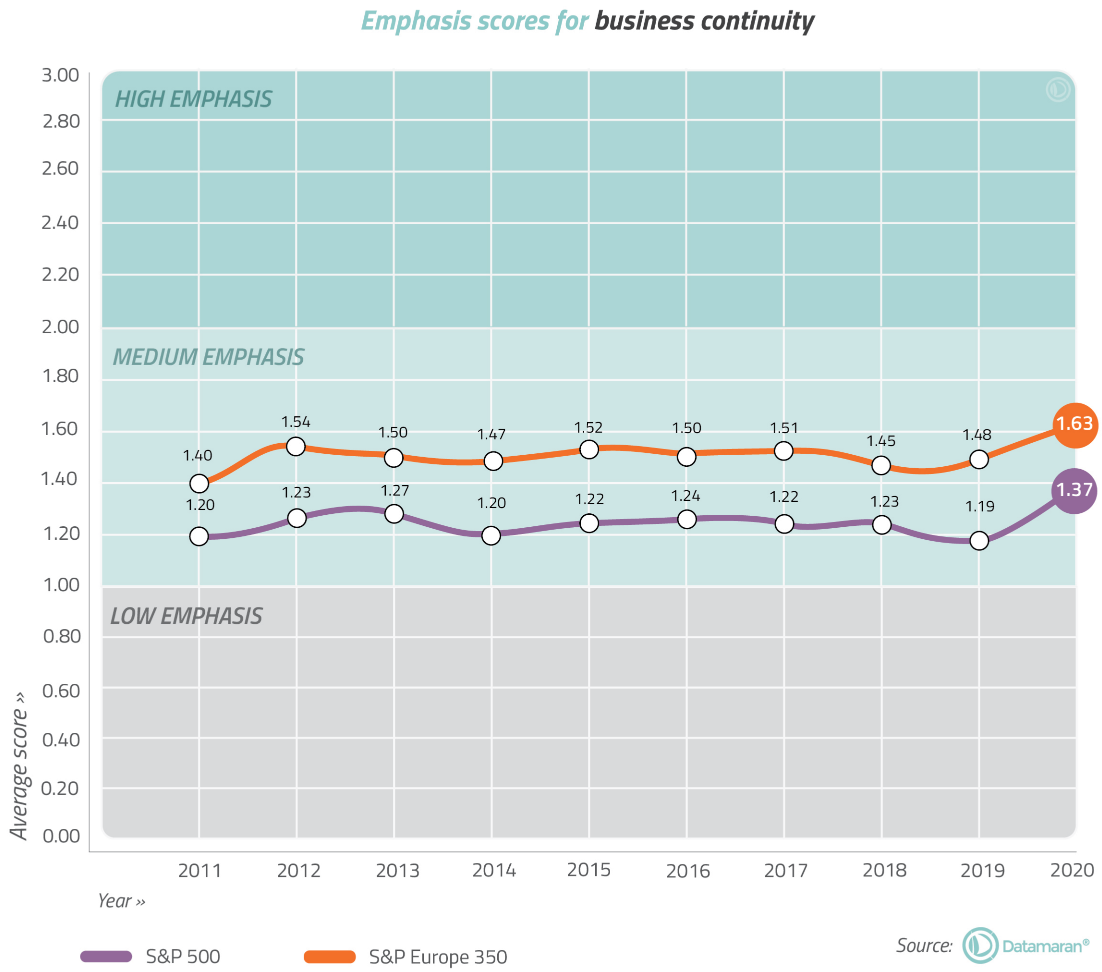
Chart 3



However, examining the level of *emphasis* that companies place on business continuity reveals that over the last decade, this has not been a major topic in financial disclosures. Given the importance of strong business continuity plans—made more evident by the current crises—the data suggest an opportunity to elevate disclosure of how companies are assessing and improving their business continuity plans.

7 "Business continuity" refers to the plans, actions, protocols, and training conducted to ensure continuity of business operations during and after disruptive events, including crisis management and response. For more information, visit the Datamaran Knowledge Base.

Chart 4



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Indeed, results from a survey The Conference Board conducted in mid-2020 suggest many of these plans need to be reexamined: almost two-thirds of survey respondents believed their business continuity/disaster preparedness plan was inadequate to address the COVID-19 crisis.[8] The survey also found that by early May, while almost 30 percent of responding companies had updated their business continuity plans, one-third of companies still had not done so.

Companies have an opportunity to build a wider knowledge around and understanding of this issue, clarify responsibilities and ownership internally, and strengthen relevant governance processes. It is also an opportunity for company boards and board committees to take a renewed look at how they identify and manage risks.

8 Rusty O'Kelley et al., *Corporate Governance Challenges in the COVID-19 Crisis: Findings from a Survey of US Public Companies*, The Conference Board, June 2020.

"We need to engage management—but in a crisis, we can't engage them with outdated data and analysis. Information is incredibly important to shaping a response to a crisis and in getting buy-in at the executive and board levels. They need to know what is going on and what is informing our recommendations. Doing so allows them to fulfill their oversight role in the most comprehensive and efficient way possible—improving performance in a structural way."

Itamar Schwartz, Director, ESG Reporting & Disclosures, Teva Pharmaceuticals

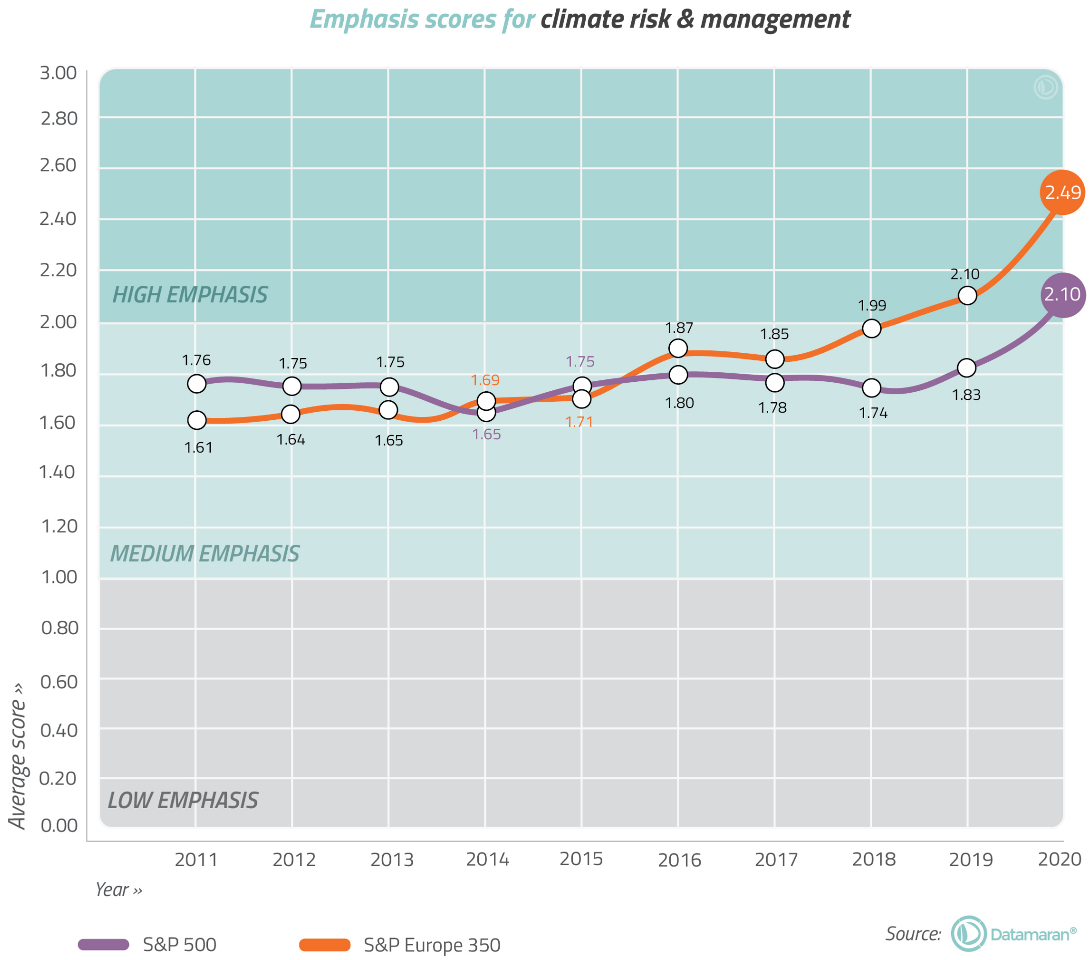
"If anything, the pandemic has demonstrated that we need more resilient systems. So for the ones of you who have been told that, being in the middle of a pandemic, there are different priorities and ESG or sustainability need to take a back seat…I think that a dynamic approach to materiality can really help you to prove why these topics are more relevant than ever, which of them are making the headlines, and why companies need to take action now."

Elisa Moscolin, Head of Sustainability & CSR, Santander UK

Climate risk disclosure has increased, but most disclosures lack specificity

Since the release of the Task Force on Climate-related Financial Disclosures (TCFD) recommendations in 2017, companies have increased the focus on climate-related issues in financial reporting. The Task Force was launched to help companies understand what financial markets need and expect regarding the assessment and disclosure of climate-related risks, and it has been a significant driver of corporate climate disclosure worldwide. Indeed, research by The Conference Board has found significant increases in climate risk disclosure over the last decade. Among the S&P 500, for example, 43 percent of companies now disclose climate-related risks, up from only 5 percent in 2012.[9]

Chart 5



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A review of *emphasis* scores finds that climate risk disclosure is not only more widespread, but companies are now also placing significantly higher levels of emphasis on this issue. In fact, as shown in Chart 5, 2019 marked the first time climate risk issues

9 *Sustainability Practices: 2020 Edition*, The Conference Board, forthcoming.

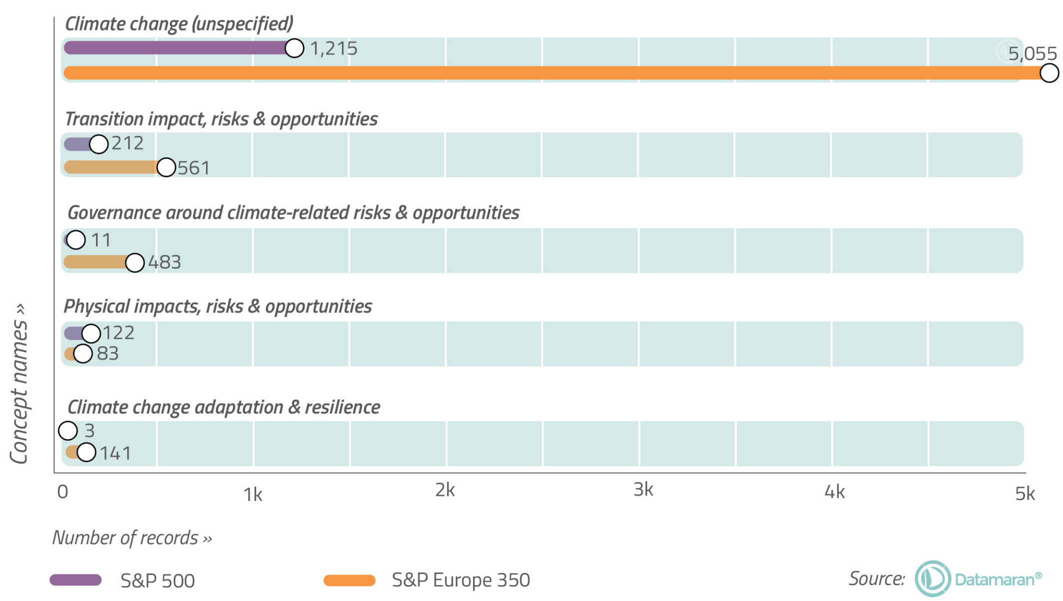
broke into the "high" emphasis category among European companies. Beginning in 2020, climate risk issues entered the "high" emphasis category for US companies as well. These trends suggest that voluntary frameworks and initiatives, such as the TCFD recommendations, coupled with increased investor focus on the issue of climate change, have had a significant effect on companies' disclosure of climate-related risks.

That said, a deeper analysis of what companies are discussing in relation to this topic reveals that most of the narrative on climate risks remains general. As shown in Chart 6, only a small percentage of company disclosures mention specific impacts and opportunities related to climate change, such as physical impacts or transition impacts. As more investors pay attention to companies' climate disclosures, these disclosures may be increasingly expected to become more specific than they currently are.

This expectation requires companies to reassess associated policies and governance practices, as well as establish clear lines of responsibility and ownership internally, around climate-related risks.

Chart 6

Distribution of climate change risks & management disclosure in climate-related concepts



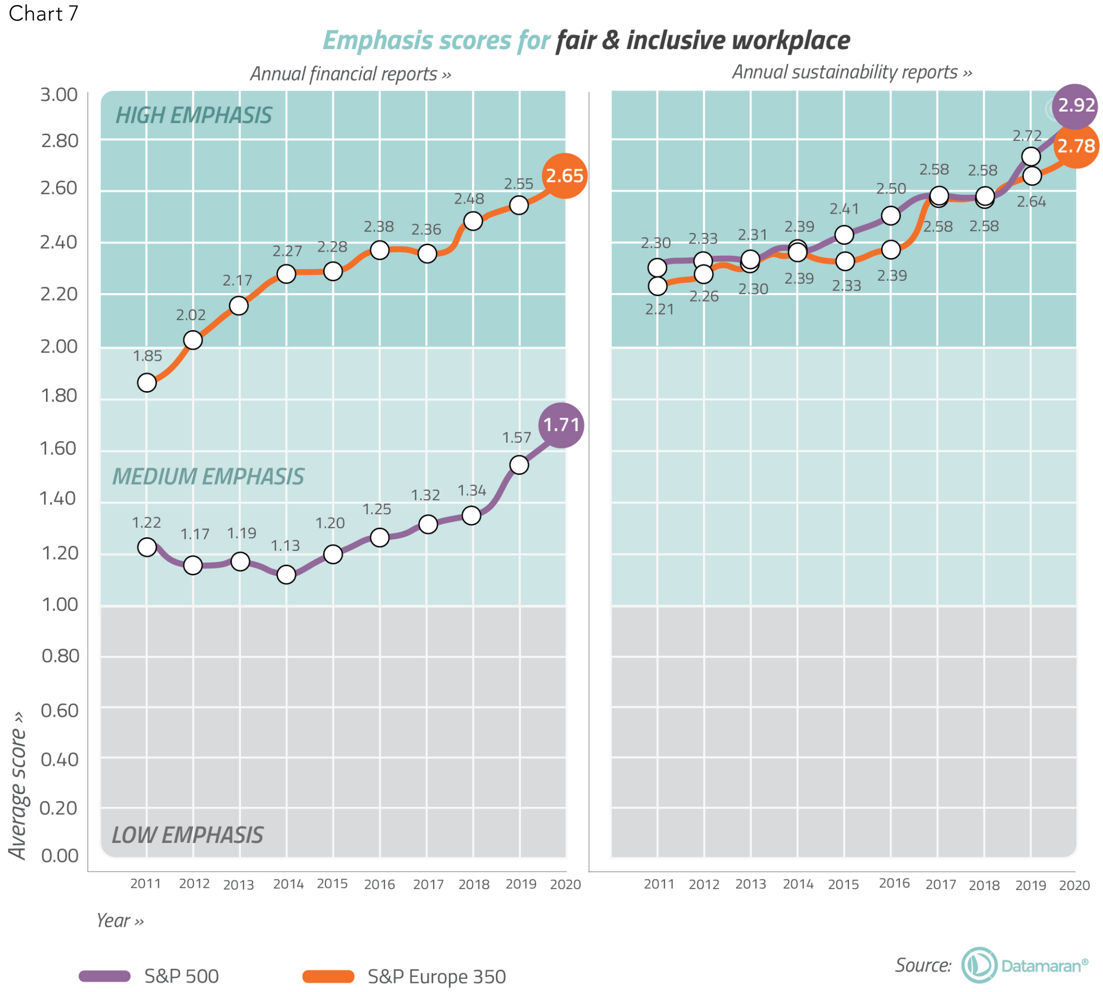
"The world is changing very fast and the amount of information generated is increasing exponentially. The human brain simply cannot process that much information, and we need solid business processes supported by technology to scan what is going on through tracking the regulatory and corporate landscape as well as online and social media changes. When considering mega-trends, such as climate change or global warming, we need a more granular view of the topic; how it is evolving and what issues it is becoming associated with. The latter is only possible if we have integrated sustainability into our organization and management systems."

Jutta Kissel, Sustainability Manager, BASF

Disclosure of workplace diversity, equity & inclusion will be increasingly in the spotlight

As shown in Chart 7, US and European companies place a similarly high level of emphasis on workplace DEI issues[10] in their nonfinancial reports. However, these issues are far less prominent in the financial reporting of US companies.

Chart 7



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In mid 2020, Datamaran explored the challenge presented by investors who are increasingly looking for US companies to provide consistent DEI disclosure.[11] Data suggest that while US businesses are making public commitments in response to the global movement around social injustice, they have been providing limited information about relevant

10 "Diversity, equity & inclusion" covers the processes, practices, and mechanisms in place to support active integration and fair treatment of all employees, with a focus on gender, age, cultural background, skills, race, religion, and sexual orientation. It considers equal opportunity provisions aimed at promoting the professional development of all employees and supporting a culture of acceptance. For more information, visit the Datamaran Knowledge Base.

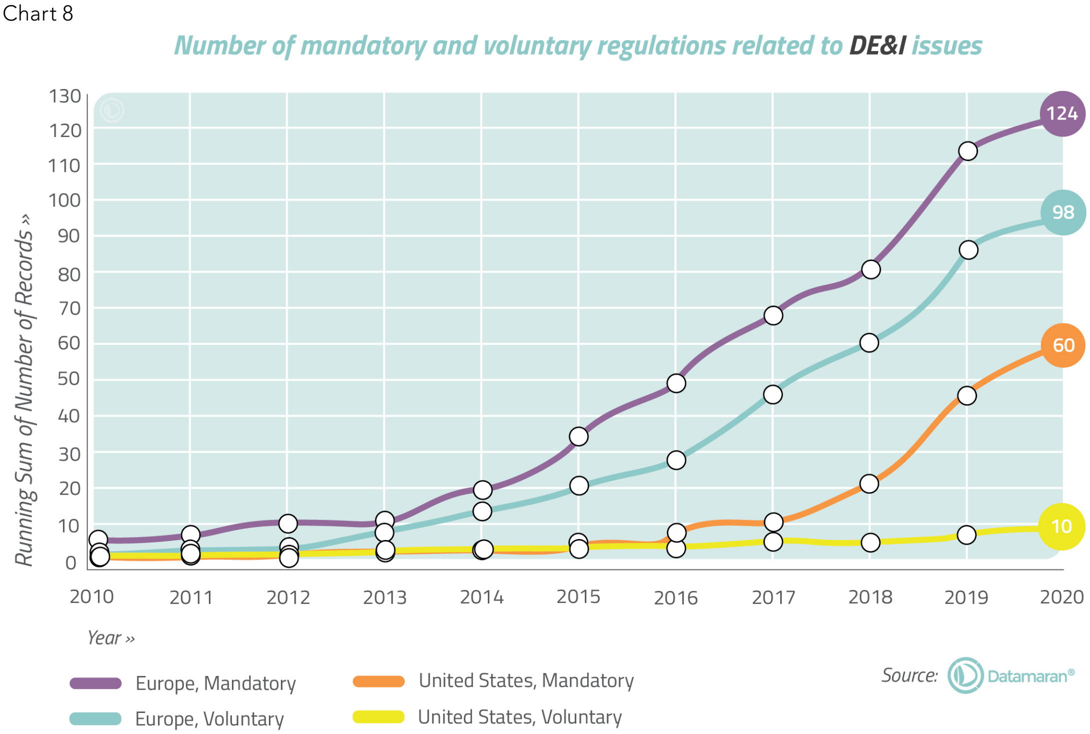
11 "US Boardrooms Fail to Reflect Country's Demographics," *Financial Times*, June 11, 2020.

policies and governance practices within their organizations—and will likely be under a microscope to do so moving forward.

Historically, regional differences in regulations related to disclosure of workplace DEI issues may be behind some of these trends. As shown in Chart 8, Europe has more than twice as many mandatory regulations related to DEI issues than the US has. The difference in the number of voluntary regulations is even more pronounced—it is almost tenfold.

However, we expect these disclosure trends may change dramatically. In late August 2020, the SEC adopted new rules that require a company to disclose, when "material to an understanding of the business," a description of its human capital resources, as well as any human capital measures or objectives that are a focus of managing the business. Given the emphasis that major investors are placing on human capital management in general—and DEI issues in particular—we expect a significant uptick in this area.[12] If they have not done so already, companies should plan to integrate more of these issues in their financial disclosures.

Chart 8



12 See, for example: "Diversity Strategy, Goals & Disclosure: Our Expectations for Public Companies," State Street Global Advisors, August 27, 2020, and "Comptroller Stringer and Three New York City Retirement Systems Call on 67 S&P 100 Companies Who Issued Supportive Statements on Racial Equality to Publicly Disclose the Composition of their Workforce by Race, Ethnicity and Gender," New York City Comptroller Scott Stringer (press release), July 1, 2020.

> "ESG issues have the capacity to fundamentally change the global business landscape—and often do. This is why ESG is and must be 'a corporate leadership trait.' However, there are different kinds of gaps decision makers need to rectify: a lack of knowledge, a lack of transparency, and a lack of the proper language in the boardroom—not to mention an ideological opposition to 'rocking the boat.' "

Ioannis Ioannou, Associate Professor of Strategy and Entrepreneurship, London Business School

Conclusion

In light of the crises of 2020 and in response to investor and regulatory pressures, we expect that companies will provide more information on climate, public health, and diversity in their mainstream financial reports. Now is a time for companies to:

- Assess whether and how they address these topics in their financial reports, and what changes would be appropriate in light of evolving business conditions and expectations;
- Consider what additional detail would be appropriate to include on these topics, which should be driven by the internal goals of the company; and
- Embrace the idea of "dynamic and data-driven materiality," so that companies remain up to date on issues that are now, or are likely to become, material to stockholders (and other stakeholders) in making decisions with respect to the company.

About Datamaran

Datamaran is the only software analytics platform in the world that identifies and monitors external risks, including ESG. Trusted by blue-chip companies and top-tier partners, it brings a data-driven business process for external risk and materiality analysis. In house—at any time.

Datamaran's patented technology offers real-time analytics on strategic, regulatory, and reputational risks, specific to your business and value chain.

Companies worldwide use Datamaran to:

- **Gain a clear view of risks and opportunities tied to** ESG, geopolitical, technology, and emerging issues—with the power of patented technology;
- **Monitor** these material and emerging risks through live dashboards; and
- **Strengthen risk management, board oversight, and annual reporting** with credible data and real-time insights.

www.datamaran.com

Contributors

Datamaran
Felix Dauth
Susanne Katus
Ian van der Vlugt

Stratagem
Shona Maguire

The Conference Board
Thomas Singer

About The Conference Board ESG Center

The Environmental, Social and Governance (ESG) Center is uniquely positioned in covering corporate governance, sustainability, and corporate citizenship/philanthropy. This combination provides our members value through in-depth research and programming in each of these areas and at the intersection of them. We offer members exclusive access to expert insights, information, and advice through a suite of offerings.

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PUBLISHING TEAM
DESIGN Peter Drubin
GRAPHICS Bart Dykstra (Datamaran)
EDITOR Sara Churchville
PRODUCTION Victoria Cooper/Chris DiStasio