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Transcript of CleanLaw: Hana Vizcarra Interviews Samantha Ross about Investor Assurance and Corporate Climate Disclosures, January 9, 2020

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Robin Just: Welcome to CleanLaw from the Environmental and Energy Law Program at Harvard Law School. In this episode, our Staff Attorney Hana Vizcarra talks with Samantha Ross, former Chief of Staff and Special Counsel at the Public Company Accounting Oversight Board and Special Counsel at the Securities and Exchange Commission. They discuss the importance of assurance in strengthening public company sustainability and climate disclosures. We hope you enjoy this podcast.

Hana: So, Sam, thank you so much for coming and being on CleanLaw with us. I have been spending a lot of time this year looking at legal issues around the disclosure of climate related information and along the way, you and I have been chatting over the last few months about the importance of adequate assurance in that process. I'm glad to be able to share some of those discussions and the thoughts that have come out of those discussions with our CleanLaw listeners today. Your career as a Securities Lawyer has included working at a firm, the SEC, and the Public Company Accounting Oversight Board. Why don't we start with you sharing a little bit more about your background and what you're doing now.

Samantha: Sure. And thank you so much, Hana, for having me on CleanLaw. I so appreciate your interest in assurance and these issues. It's kind of an arcane area, but it's super exciting and I hope that we can explain why in this podcast. As you said, I am a securities lawyer. I spent the last many, many years as one of the original staff of the Public Company Accounting Oversight Board, which was established by the Sarbanes-Oxley Act of 2002, it was established in 2003, to oversee the audits of public company financial statements. And in that capacity, we set up an organization that could register, inspect and set standards for the auditors of public companies. And in doing that, we've thought a lot about how to improve the audit, how to make it more informative for investors.

Samantha: And along the way, we did a ton of engagement with investors and they were often saying just after a while, "We really like what you've done to help improve the quality of the financial statement audit. But there's a lot of information that we care deeply about that's very material to our investment decision making and our stewardship that is not in the financial statements and we do value assurance," which I thought it was great to hear, "And we want to understand how we could get more assurance over that new kind of information."

Samantha: So since I left the PCAOB last year, I'm now working with investors to explore ways to use assurance to improve the quality and rigor of material disclosures that are outside the financial statements. And in that regard I've been involved in some research to look at the current state of assurance. It's voluntary assurance over voluntary sustainability reporting and come up with some interesting findings. That's how we got started talking.

Hana: Yeah, that is. That's how we started talking and sort of one of those new issues is really related to the integration of climate information into disclosures. I think it would make sense to have a quick pause here and chat a bit about securities law and materiality and how that fits into this discussion. So a key feature of US securities law is that there is information that only needs to be disclosed to the SEC and investors if it reaches a certain threshold of importance. That is, it is material. And the definition of material information is highly dependent on what an investor thinks. Because when a court considers whether information that is misleading or was admitted by a company meets the threshold for materiality, they ask whether a reasonable investor would have found that material to their decision making in light of the total mix of information available.

Hana: So this issue of what investors think is material is incredibly important to this discussion and it's a key aspect of determining what companies should disclose. So this conversation that you've been having over the years with investors about new areas is particularly important on the climate front, the Financial Stability Board created the Task Force on Climate Related Financial Disclosures in 2015. The creation of the TCFD and recommendations that came out of that kind of elevated this discussion and focus it around certain topic areas. They weren't the first to push companies to expand the climate related information and corporate disclosures and I'm really focusing on one piece of what you do. What you do is certainly much broader than climate, but since that's the focus that I've had this year, I'm giving a little bit of background here. The TCFD's leadership has helped focus the effort that was previously occupied by a number of different advocacy organizations and other players.

Hana: This was important because it was an industry led effort and it required public companies and the financial industry to kind of get on the same page as far as considering what's important in disclosures in this area. And it's allowed us to kind of move beyond general talking points to implementation and thinking about what does it really mean to disclose more information and more financially relevant information around climate risks and opportunities. But even with the TCFD's guidance on implementation, and they have some guidance that's specific to particular industries, translating that to real companies and considering a particular jurisdiction's legal framework like US securities law and the definition of materiality is challenging and it's an ongoing effort.

Hana: With that background, explain to us sort of the place of assurance in this discussion. Why it's important? How it relates to this larger discussion of sustainability and climate disclosures? Because it's really from talking to you and what I've learned is it's a really a key piece for making this successful.

Samantha: So assurance is a tremendously important tool to help users gain confidence in the quality of information that they're using. And essentially what it does is a couple things. First of all, people are most familiar with it probably in the context of the financial statement audit that investors attach to the company's annual financial statements. And auditor's report, it's usually a boilerplate report that tells investors that the auditor conducted an audit and dug deep into the issues and has been able to reach an opinion that the financial statements are fairly presented in all material respects. It's a tremendously important benefit to investors to know that the information that they're using has been tested by an independent expert third party.

Samantha: But that's not all of what an audit delivers. That's the visible portion of what the audit delivers. But as or more important than that is that an assurance provides a benefit to investors behind the scenes and that's a tremendously important benefit. Because what it means is you've got an independent expert person probing the disclosures, testing them, talking to management about them, really deepening management's own thinking about the disclosures they're making. It results in a much more rigorous disclosure. It results in a much more rigorous process for developing the disclosure. And that itself, while invisible to people on the outside of the company, that's a tremendous benefit. It's a benefit to investors. It's a benefit to boards. It's a benefit to management, in fact, to have that exercise of having someone else test their disclosures and really challenge them and help them think through how to make sure the disclosures are clear, complete and informative.

Hana: It sounds really like that process, beyond just benefiting the disclosures and the information coming out, could have a significant impact on the internal management processes of a company and influence corporate governance procedures and risk management and a number of other things.

Samantha: I think it does. The primary goal is to provide more reliable disclosures for investors to help prove the reliability and disclosures give investors a basis for confidence and information, but I'm just saying it also has the sort of knock on benefit of helping boards make sure they can feel comfortable that the statements that are issued by the company are accurate and reliable and it even does help management to have to go through that exercise, I think.

Hana: And when it comes to climate or sustainability reports, we're seeing a lot more of those reports and we've had sustainability reports from companies for a long time. We're now seeing more sophisticated reports with more data, with more information of financial connections. We're also seeing more targeted reports focus specifically on climate issues. Some of them do have some level of assurance noted in these reports. What is the state of assurance when it comes to that type of reporting right now?

Samantha: This gets back to your statements about materiality. I mean, materiality is not a static thing. It evolves over time, it evolves as markets shift, as new challenges arise, it evolves as investors understand new matters that may impact a company's long-term strategy or long-term viability, especially when it comes to the climate disclosures. So, we have seen a dramatic shift in the kinds of information that companies disclose to investors through the engagement that investors have done with companies over the last several years.

Samantha: Last fall, the Investor Responsibility Research Center put out a report on the state of sustainability disclosures and they found that 78% of the S&P 500 companies now publish sustainability reports. Those are usually standalone reports that are available on a company's website. They include a lot of different kinds of information. There are no requirements for how the companies report sustainability information, but there are several different reporting standards that companies can use voluntarily.

Samantha: As you say, sometimes companies have voluntarily gotten assurance over some of the disclosures that they include in their sustainability reports. The Investor Responsibility Research Center studied that to an extent and they found that 36% of the S&P 500 companies that publish sustainability reports, so I said 78% of companies in the S&P 500 do sustainability reports, 36% of those companies routinely obtained some kind of third party assurance. So I thought that was very interesting because it's voluntary. It's not required. The financial statement audit is required by law. Every company has to have it. I thought it was very interesting to look at what companies, auditors, and investors were using in assurance, who was using it when it was voluntary.

Samantha: So I dug a little deeper in that and found some very interesting things. There's a lot of variety of different kinds of assurance. The assurance is usually not of the whole report. In fact, it's almost never of the whole report. And the most common thing to be assured is in the climate space, it's the greenhouse gas disclosures that I think it's 90% of the assurances over greenhouse gas disclosures.

Hana: Yeah, I think some of the energy company reports I was looking at over the last year, that was what I saw, mostly it was just assurance of the GHG emissions numbers.

Samantha: Right. I agree with that. It's not just energy companies, it's broader across the whole S&P 500, that's probably the dominant area where there is assurance but there's a lot of variety and just even what kind of assurance companies get, there are choices.

Hana: Yeah. Explain to us a little bit about what that means, sort of the different levels of assurance and what that means for what the auditor is actually doing.

Samantha: There are a couple of different kinds of levels of assurance, I guess you could say, that we found. People are most familiar with what we call reasonable assurance. That's the level of assurance in the financial statement audit. What that means is that the auditor has used risk assessment to plan the audit in order to uncover anything that would be necessary to find a material misstatement or omission of fact. So the auditor uses their expertise to conduct that risk assessment and decide what procedures they should follow. Of course there are robust audit standards as well that they have to follow. The work that they do allows them to come to an opinion, and that's an important word in the lingo, that the financial statements are free of material misstatement or omission, that they're fairly presented in conformity with a particular reporting framework. Usually GAAP, or it could be the International Financial Reporting Standards and that the financials are free of material misstatement or omission.

Samantha: That's reasonable assurance. That's what people are used to. The assurance that companies obtain over information outside the financial statement though varies. Certainly reasonable assurance is one of the areas and that's a high level of assurance that is most valuable to investors. I call that investor-grade assurance. But some companies, actually most companies instead get what's called limited assurance. Of course, this is voluntary so they're able to do this, but that assurance doesn't result in an opinion, because the auditor is not doing a risk assessment and uncovering the information that they would need to, to come to an opinion that the disclosure is free of material misstatement or omission.

Samantha: But instead they do certain procedures. They usually state what the procedures are, best practices is that you state what the procedures are and then they reach a conclusion that having performed those procedures, nothing came to the auditor or the assurance provider's attention that any of the information was inaccurate.

Hana: That would mean that there's probably quite a range within the limited assurance category as to what that really means. Right? Because it depends on what procedures they chose for that particular audit.

Samantha: Absolutely. Very broad range. In fact, just in greenhouse gas disclosures, which is the most common area of assurance, the assurance provider might've done a site visit, which is very valuable and important, or they may not have done, it may be just a desk review. Some of the assurance statements that we've pulled disclosed that it was just a desk review. Sometimes they don't disclose it, but they don't say anything in the assurance statement about having done any site visits. So, that's very telling. Sometimes they'll have statements about looking at the process by which information was gathered that gets more into whether there were good controls over the process that would be more valuable than if you were just looking at a spreadsheet and checking the numbers over again.

Hana: Are there guidelines for this type of assurance when you're looking at outside of the more typical financial disclosure context? Are there guidelines for them to follow or is this sort of being developed in house at individual auditing company firms, they're developing new processes for this?

Samantha: There are no required guidelines because it's voluntary, but there are a lot of different guidelines that are available to point to, and most assurance providers do point to some kind of guideline. But let me step back for a moment because you just used that phrase auditor. And I should be clear that in the sustainability space there are a range of providers providing these assurance statements and some of them are the traditional accounting firms that have expertise in auditing, but probably more of them are not that kind of a firm. There are some very old line marine testing companies that are pretty dominant in this space and then also there are sustainability consulting firms that provide assurance services as well.

Samantha: We've also noticed there is a variety of expertise of the providers. Sometimes some providers have, especially at some of these sustainability consulting firms have PhDs in certain science topics. That seems very impressive. But then at the same time they may not have a background in assurance itself, what it means to be an independent tester. Other assurance statements we've found, we've looked up the people because sometimes the names of the people are listed and the people are much less qualified, where some just in a poor, egregious end of the spectrum. They don't even necessarily have college degrees. But it's all checkable. We found that through public information, so that should be factored in when an investor thinks about how much weight they put on an assurance statement.

Hana: And this creates a bit of a minefield for investors, right? Because the purpose of assurance in the way they're used to dealing with it is to give them some level of security that the information they're looking at is complete. It includes what needs to be in there and that the company has sort of done a good job of complying with their obligations. Now, we are looking at, this of course is a voluntary environment, but from an investor standpoint I would expect that they're hoping to get that kind of level or at least be able to use whatever type of assurance statement they get in a similar manner, even if they have to consider it's maybe done at a different way. And all of the things you just mentioned make me think that may not be a reliable instinct for investors to follow.

Samantha: Well, I think investors should read the assurance statements that they receive, because they are voluntary and there is such a wide range. I've seen some examples of really excellent assurance statements where there's high level of assurance, reasonable assurance, as I was describing, performed by people that at least on paper look like they are very competent. And I think that kind of assurance can add a lot of value to investors both in terms of their confidence in being able to rely on the information as well as, I think, that the probing, as I discussed before, helps the disclosure be more rigorous. Investors have complained and lamented the poor quality and reliability of ESG disclosures. So I think this is actually a real opportunity both for investors and companies and assurance providers to improve the quality and rigor of the disclosures and reap the benefits of that both in the capital markets and in terms of long-term having a better foundation for using information.

Hana: Do you have particular guidance on where you would like to see this field go as far as making sure that the diversity of approaches is leading towards some best practices, that investors have a good sense of what they need to be looking for and asking for? What are your thoughts on sort of how this should be developed at this point?

Samantha: Well, I think the best assurance is at the reasonable assurance level and then an investor can be confident that an independent third party explored the disclosure behind the scenes, looked at backup data and really challenged the disclosure behind the scenes and then can come up to an opinion saying that the disclosure is fairly presented and accurate in all material respects. I think that's the most helpful to an investor. It's important that it'd be done by somebody who's highly competent and who understands what it is to be independent and what it is to be expert in assurance. That you have to have a mindset of skepticism, you have to understand the subject matter and know how to ask the right questions. It doesn't have to be skeptical if you don't really understand the subject matter. You can't really apply that skepticism in an effective way. So you need both.

Samantha: And I think there's also another piece of assurance that's really helpful to investors that people don't think about because it's sort of implicit in the financial statement audit. But that is that assurance can also help investors understand whether the reporting framework or the metric that is being disclosed is itself even suitable, because that's been a risk in the ESG space and other kinds of non-GAAP disclosures.

Samantha: Investors sometimes question whether the measure is itself properly constructed, whether any kind of methodology changes from period to period behind the scenes are disclosed, so investors know if they're comparing apples to apples, that's of course suitability - what we call suitability. That is very important. It's very important in the financial statement context. But it's fairly implicit, because in the financial statement context we have generally accepted accounting principles and internationally we have the International Financial Reporting Standards and those are really, at least in our markets, those are the two reporting frameworks that can be used.

Samantha: So you can kind of take for granted that the reporting framework is suitable, but it's a totally different story in the sustainability space. And as I mentioned, there are several entities who are working very hard to set forth good reporting standards, but companies still have the opportunity to pick and choose because this is all voluntary. So I do think a major benefit of assurance is that an investor will be able to understand whether a company has presented suitable criteria that they're measuring against. It can also help when a company tries to use metrics that aren't in a reporting framework.

Samantha: And let me say the reporting frameworks we have, the Global Reporting Initiative. We have the Sustainability Accounting Standards Board. You mentioned the Task Force on Financial Disclosures that the Financial Stability Board set up. There are several different frameworks that a company might use depending on what's important to their investors. But sometimes there's really important information that's not in a framework and a company wants to disclose that information to their investors. Again, it's very important that investors understand that the measure itself is suitable. So that’s what assurance can provide. Under the existing auditing standards, it's required that an auditor assess the suitability of the framework. And like I said, in the financial statement context, it's a pretty easy assessment, it's taken for granted for the most part. But in the sustainability space, there's real value there.

Hana: And I think that brings up a good point of, you mentioned the variety of frameworks for reporting that exists right now and a lot of them are ... some are more detailed than others and they're all starting to try to align to some degree with this larger TCFD framework, which is a little more general, but there's still a lot of work going on to develop what disclosure looks like in this space, particularly when it comes to climate change and the impacts of climate change. And so that pairing of assurance, one of the things you and I have talked a little bit about before is the importance of developing assurance practices for this particular type of information alongside the development of the disclosure guidelines and frameworks. Because if you can't assess suitability then they're not going to be particularly useful. And I think you did just a great job explaining sort of what the purpose of that is and the importance of having those two sides sort of parallel tracks of efforts happen at the same time. And not have one be forgotten in favor of another.

Samantha: I really like how you put that. It's definitely a parallel track. I mean, there's the reporting criteria, there's the reporting standards or the reporting metrics that a company uses, and then there is assurance. It's a different thing. The assurance doesn't set out what the reporting standard or metric would be. Assurance tests whether the disclosure against a stated reporting standard or stated metric, whether that disclosure is accurate. That's what assurance provides you. So assurance is a process by which it should be an independent third party looks at the disclosure, looks at the reporting criteria, assesses whether the reporting criteria in the first place are suitable, because they might not be suitable and if they're not suitable, that's very important to know at that point, and assurance providers should step away from the work.

Samantha: There's no need to go forward and actually test the work against a criteria that are unsuitable, it usually has the effect of then causing the company to rethink. "Well, I guess that we need to change or better adhere to the reporting criteria that we've pointed to or we need to come up with, if these are bespoke metrics, we need to come up with a metric that is more appropriate and more fair." Maybe there've been some changes behind the scenes to the metric that need to be disclosed, because a year ago the company disclosed under one metric and if they're changing the metric that needs to be disclosed.

Samantha: So that alone, like I said, it's very valuable exercise. But once you get through that exercise, then what assurance does is test that what the company has stated in their disclosures is accurate, and there are lots of tools that an assurance provider has to do that, and it depends to some extent on the subject matter of the information. Then, ultimately the assurance provider comes up with a totally separate statement from the company. The company will have their disclosure and the assurance provider then will have a statement or even better an opinion. So, you'll have the company statement on the one hand, and then a totally separate statement by an independent third party that tells investors that the company statement is accurate.

Hana: Right now we're kind of going through what to some of us feels like a new and unique moment in time, where we're dealing with a very complicated set of new concerns, particularly related to the climate question, that have to be incorporated into disclosures and thought about as far as what the criteria are for disclosures. What then assurance looks like to accompany that. How should the regulators be thinking about this? Are there examples we can look to in the past whether the SEC, PCAOB have had to think about new and novel questions and kind of create new guidelines around them?

Samantha: You know, as we've been talking about this area of climate disclosure is largely voluntary, especially in the United States, although companies do need to disclose any material climate impacts, there's no set framework for how they do that.

Hana: But there is a lot of push to move in that direction I think. There's certainly a lot of discussion around that.

Samantha: That's right. There absolutely is and I think as we have that discussion, I do think it's going to be very important to talk about assurance over the information at the same time because if the information is important enough to affect a total mix of information investors use for their decision making, it's in my view, important enough to have assurance over it. I think climate is a great example. It's a special example if not necessarily unique example of how sustainability disclosures can be material, because I think a lot of sustainability information can be material to different companies in different industries.

Samantha: But in the climate area, this is what the Task Force on Financial Disclosures studied very deeply. The way the TCFD describes it is there ought to be a discernible through line between the climate disclosures and the financial statements themselves. And I think that's a very important concept because I think it tethers the climate disclosures to the overall financial reporting and that's what the TCFD was after.

Samantha: So if you're going to do that. I think one of the best ways to build that through line and keep to be a strong through line is to make sure that assurance is involved. The financial statement auditor will be thinking about climate impacts if they're material to the financial statements. But it's certainly helpful if there's a robust climate disclosure system. And this is, I think, where the TCFD was. There's a robust climate disclosure by the company that then the financial statement prepares at the company and the financial statement auditors can use and refer back to. So I do think that'll be an important direction where this heads.

Hana: So, Sam, can you give us a few key takeaways that we should be thinking about when we're talking about improving disclosures in the sustainability and climate space?

Samantha: Sure. So, what I'd leave you with is to remember that sustainability reporting itself would not exist without investor demand for it. And if sustainability information is important, as it clearly is, then it's important to know that it's reliable. Third party assurance exists to meet the needs of investors and other users to know that the information that they need and rely on is reliable. And some companies are starting to provide assurance from independent third parties in order to deliver that reliability.

Samantha: In some cases, it's a very high level of assurance and it's very useful. I think those are really great developments. But in many cases, it's a missed opportunity, because the assurance that they've obtained is too low level, too weak to really deliver reliability. I think, because this is a voluntary endeavor, improvements in sustainability reporting are not going to occur unless investors seek out opportunities and platforms to make their desire for meaningful assurance heard. But I think it will deliver true value and will be well worth it. So, thanks Hana for giving me this opportunity.

Hana: Well, thank you so much for joining us. This has been a really interesting conversation and I think an important one, because there's so much discussion over the disclosures in the climate space, over disclosures and how they should be developed in particular industries and the detail that should or shouldn't be in them. And you've demonstrated how incredibly important it is to keep in mind this other piece of that larger process, how it fits into it, and the benefit it provides to improving the quality to really, giving the level of service that investors expect from the disclosures that they're asking companies to provide. So thank you again, and I look forward to continuing this discussion in our work and seeing what else you do.

Samantha: Well, thank you to you, Hana, to CleanLaw and to the Harvard Law School for showing interest in this area.

Hana: Absolutely.

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