How an ESG reporting strategy can benefit your company

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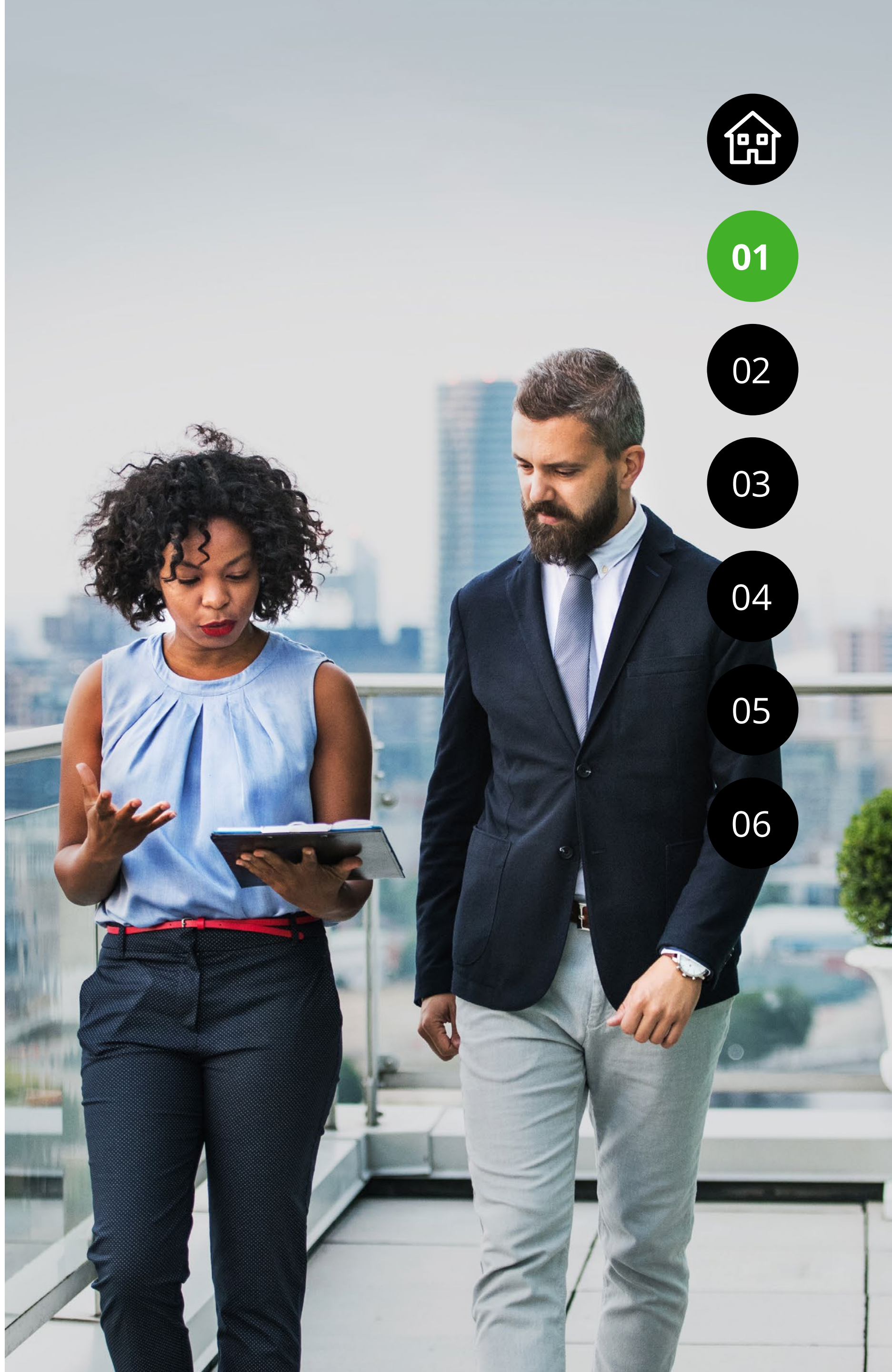
Introduction

Introduction

As environmental, social, and governance (ESG) performance is shifting from voluntary to mandatory—with initiatives like the Corporate Sustainability Reporting Directive (CSRD) in Europe and the Securities and Exchange Commission's (SEC) climate-related disclosure regulation in the United States—companies should be working to assess and mature their ESG reporting strategies.

Anyone who experienced the early years of Sarbanes-Oxley (SOX) likely knows that it takes time (often multiple reporting years) for new processes to be considered "audit-ready." Forward-thinking teams understand there is typically a learning curve as new areas of their business are brought into scope. These companies often aren't waiting around to start making the necessary investments in processes and technology to start maturing their ESG program management efforts.

As timelines accelerate, regulators are not the only ones behind the growing demand for consistent, comparable, and transparent ESG and climate-related disclosures. Consumers and investors are often choosing to spend and invest their money with businesses they view as operating responsibly. These developments indicate the general market is becoming serious about ESG performance. Here's what's happening in the regulatory environment and what it might take to level up your ESG program.



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Regulatory activity

Regulatory activity

Given the global reach of certain regulations, it's becoming harder for companies across the board—public or private, domestic or international—to avoid ESG disclosure. Let's break it down.

United States

The SEC has finalized a set of new rules[1] to enhance and standardize climate-related disclosures. The new disclosures include:

- Climate risk management
  - Documenting the process for identifying, assessing, and managing material climate-related risks.
- Strategy
  - Describing any climate-related risks that have had or are reasonably likely to have a material effect on the business either in the short- or long-term.
- Governance
  - Disclosing information about how the board oversees the assessment and management of climate-related risks.
- Climate targets and goals
  - Documenting material climate targets and goals including the timeline, plans to achieve those goals, and any current progress.
- Greenhouse gas (GHG) emissions (Scope 1 and Scope 2)
  - Large accelerated filers or accelerated filers (other than SRCs and EGCs) are required to disclose material GHG emissions related to a company's owned or controlled operations (direct and indirect emissions). These disclosures must include assumptions, sources for the data, and the calculation methodologies.
- Material expenditures and impacts
  - Disclosing quantitative and qualitative information about material expenditures and impacts on financial estimates and assumptions that are the direct result of (1) mitigation of or adaptation to climate-related risks, (2) disclosed transition plans, or (3) the disclosed targets or goals, or actions taken to achieve or progress toward those targets or goals.
- In addition, there are specific disclosures related to internal carbon pricing, transition plans, and the use of scenario analyses that must be provided, if a company utilizes such information and it is material.

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United States *(cont'd)*

- The financial statement impacts of climate-related events and transition activities, including:
  - Disclosing certain specified financial statement effects of climate-related events, including severe weather events and other natural conditions, subject to a de minimis threshold.
  - Disclosing information about carbon offsets or renewable energy certificates when a registrant's use of them as a material component of its plan to achieve its disclosed climate-related targets or goals.
  - Disclosing material impacts on financial estimates and assumptions that are due to severe weather events and other natural conditions or disclosed climate-related targets or transition plans.

Scope 1 and 2 GHG disclosures will be subject to limited assurance during a phase-in period for large accelerated filers and accelerated filers, followed by reasonable assurance for large accelerated filers. Companies will have a safe harbor from liability for certain disclosures.

The SEC has stayed the effective date of the final rule pending judicial review of petitions challenging it. The stay does not reverse or change any of the final rule's requirements. Since the outcome of the litigation is unknown and the review may take several months or longer, it is uncertain whether the SEC will retain or extend the final rule's existing mandatory compliance dates. Irrespective of this uncertainty, companies will need to make decisions related to implementing the rule's requirements.

This uptick in reporting requirements doesn't just apply to public companies. The Biden administration has proposed a rule[2] requiring major federal contractors (public or private) to publicly disclose their GHG emissions and climate-related financial risks. Under the proposed rule, they must set science-based targets[3] for emissions reduction. Disclosure requirements would scale based on the federal contractor's volume of annual federal contracts, with the maximum disclosure requirements including Scope 1, Scope 2, and relevant categories of Scope 3 GHG emissions.

Although the SEC's final rule applies only to publicly traded companies, the proposed rule for federal contractors would apply to private and public companies alike if the threshold for annual federal contracts is met, underscoring the importance for all companies to understand the potential impact of ESG rules and regulations.

Regulatory activity

European Union

The European Parliament has adopted the CSRD and the accompanying European Sustainability Reporting Standards (ESRS), with reporting set to begin as early as 2024. ESRS is much more robust than the SEC's climate disclosure rules and consists of 12 standards across environmental, social, and governance matters. CSRD also includes a stakeholder-focused double materiality assessment that will require companies to specify how sustainability matters affect the company and how the company's activities affect people and the environment.

While the majority of listed companies in Europe will be subject to these new disclosure requirements, CSRD will also apply to companies not established in the European Union but that are listed on EU-regulated markets, as well as EU subsidiaries of non-EU companies. This means that many US-based entities are going to be subject to these requirements; in some cases, under a more accelerated implementation period than the SEC climate disclosure requirements, and with an expanded scope of reporting and assurance requirements.

For US companies, operations in the European Union may be subject to multiple new disclosures, including:

- ESG matters such as climate-related environmental disclosures, non-climate environmental disclosures (e.g., pollution, water and marine resources, biodiversity and ecosystems, resource use and circular economy), workforce, affected communities, consumers, and business conduct.
- EU taxonomy and impacts on sustainability matters.
- The impact of priorities around sustainability development, performance, and position.

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Regulatory activity

Other international developments

In the United Kingdom, large companies[4] began mandatory climate-related reporting in April 2022.[5] The reporting requirements are based on recommendations set forth by the Task Force on Climate-related Financial Disclosures (TCFD).[6] Hong Kong, Singapore, Japan, and Malaysia have all announced their own mandatory climate disclosures in line with TCFD recommendations as well.

The United Kingdom has also signaled its intention to mandate disclosures aligned with standards set by the IFRS Foundation's International Sustainability Standards Board (ISSB), a sister board to the International Accounting Standards Board. ISSB released its initial two standards (IFRS S1 and S2) on June 26, 2023, with plans to release broader standards over the coming year. China has also revealed plans to adopt ISSB, and the Association of Southeast Asian Nations (ASEAN) Taxonomy Board released the ASEAN Taxonomy for Sustainable Finance to help member states address environmental disclosure objectives.

Finally, the IFRS Foundation recently announced that TCFD monitoring responsibilities will transfer to ISSB in 2024.[7]

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Building an effective ESG program

Building an effective ESG program

With this new wave of mandatory reporting just around the corner, most regulated entities in the United States and European Union are facing fairly aggressive timelines to begin maturing their programs. In order to meet these pending requirements, a company should understand where it stands today to determine what progress may look like. AuditBoard has broken down ESG maturity into four distinct stages: fundamental, efficient, strategic, and groundbreaking.[8]

01 Fundamental

This represents a company that's just getting started with their ESG program. They likely have yet to adopt any guidance frameworks, publish an ESG report, or complete a materiality assessment. The company typically handles data collection on an ad hoc basis while fielding questions from customers and investors. In most situations, multiple teams—such as legal, investor relations, financial reporting—or the broader enterprise risk or SOX teams are responsible for producing ESG information.

02 Efficient

At this stage, a company has become more efficient in its approach to ESG. Typically, governance is in place or is in the process of being defined, ownership has been established, and data collection has begun. Companies at this stage are generally ready to identify relevant frameworks and carry out a baseline materiality assessment. From there, many early-stage companies are beginning to calculate their carbon footprint and release their first ESG report.

The company may be carrying out some internal audits, but ESG controls and assurance are likely still in the future. For now, the focus is mainly on refining the teams, processes, and technology required to support more robust ESG program management and data collection.

03 Strategic

As companies continue to mature their ESG programs, leadership teams typically start to view ESG as a leading competitive advantage. This prompts executives to include ESG strategies across the organization. At this point, companies are often aligned with multiple frameworks, and one or more rating agencies, and are spending more time ensuring the company has strong ESG scores. It's important to note that companies at this level of maturity generally view chasing ESG ratings as secondary to establishing a strong governance program and setting and achieving their own internal targets.

This is the stage when companies start to identify ESG controls and generally have technology in place to support the process throughout. Typically, a dedicated ESG or sustainability team leads robust data collection and materiality assessment efforts. The company probably has issued multiple ESG reports with net-zero and decarbonization disclosures and sometimes even third-party assurance on GHG carbon emissions data (but unlikely broader assurance on other data).

04 Groundbreaking

Companies that are considered "groundbreaking" generally have been issuing sustainability reports for at least five years; have large teams with robust data collection efforts, much of which are automated; and they've invested heavily in technology such as an ESG program management solution[9] and a carbon data lake to aggregate data. These companies typically have invested in a public ESG posture, and their peers look to their reports for leading practices to emulate. At a minimum, these companies have already issued a public net-zero or other decarbonization target and are obtaining limited assurance on GHG data and, in some cases, full assurance on the entire report (although still rare).

Behind the scenes, these organizations often have documented their upstream internal controls and are starting to test them, often with help from their second-line risk and compliance teams. ESG strategies have likely been aligned to internal audit, risk, finance, and broader sustainability initiatives in addition to being mapped to the company's strategic business objectives. A large, globally dispersed ESG team typically marshals the resources to innovate, meet new commitments, and communicate progress to internal and external stakeholders in regular internal updates outside of the annual reporting cycle.

04

The journey to integrated ESG reporting

The journey to integrated ESG reporting

ESG reporting may seem fragmented and fraught with ambiguity today, and the regulatory landscape is evolving rapidly. We're seeing consolidation among existing frameworks, with requirements being incorporated rather than retired. Although ESG reporting is still in its early days, the teams and roles associated with sustainability are starting to become more consistent from one organization to another. ESG teams often include people with a variety of backgrounds including audit, risk, compliance, and sustainability. Further, we are seeing many ESG teams leaning on their financial reporting counterparts and leveraging the lessons learned from the past 20 years of SOX.

Some still might ask: Is ESG worth the investment? It seems so. There is a clear trend that more regulation is coming, and it doesn't appear that customer or investor demand is slowing down. Depending on where you are on your journey, remember that you're not alone. To keep pace, look to your peers and benchmark your performance against others in your industry, market, and region. While agility will likely be a factor in effectiveness in this rapidly developing space, having the insights to make the necessary investments early to give you time to learn and refine your processes can pay off in the long run.

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