TBH Consulting LLC

ESG Reporting

Executive Summary

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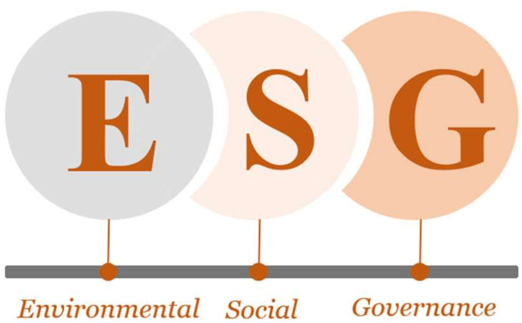
I. Overview

What is ESG?

Over the past decade, many investors have shown increased interest in understanding how companies address sustainability and ethical world issues. ESG metrics are the three areas that entities focus on to address these important matters: environmental, social, and governance. These areas have seen increased attention driving more companies to pivot their approach of gaining the trust of their stakeholders through their ESG efforts.



Environmental

First, investors are concerned with how a company's operations impact the environment in which it exists as the topic of sustainability grows. One of the main metrics within the environmental section that investors heavily focus on is the measurement of greenhouse gas emissions.

Greenhouse gases are defined as gases that trap heat within the atmosphere. The most common greenhouse gas is carbon dioxide. According to the U.S. Environmental Protection Agency, carbon dioxide made up 79% of the total US emissions in 2021. Carbon dioxide is produced by the burning of fossil fuels, trees, and solid waste.

Fossil fuels are considered to be non-renewable resources that come from the earth such as natural gas, oil, and coal. Fossil fuels are heavily relied upon for the purposes of creating heat, generating electricity, and powering engines. All three of these areas are utilized on a daily basis for companies to operate. As a result of increased demand for environmental or carbon footprint reporting, companies have begun to strategize on how to become carbon neutral in the future.

In addition to greenhouse gas emissions, companies focus on climate change, waste management, pollution control, and other environmental factors. It is common to see a wide variety of focus areas within ESG reporting as the topics vary depending on the industry and operations an entity is involved in, including:

Social

Another key area of concern for investors that entities have brought to the front of their focus are social issues. Social principles reflect the relationship between a company and its stakeholders, employees, and customers. Companies desire to be inclusive of both internal and external social issues. When companies include social factors within their ESG reports, it often includes the following topics:

Social metrics were initiated as a result of company employees demanding better working conditions, diversity and inclusion efforts, and asking for more involvement with social issues in the community. Social topics are not newly identified issues, but there are more requirements being formed around a company's transparency and reporting on the matter.

Governance

Similar to the social principles, governance is not a new topic for companies. However, recently, entities are either being required or encouraged to disclose to stakeholders how they approach regulating themselves. Investors want to know what management is doing to make the company more ethical and sustainable. Common governance topics include:

GOVERNANCE

Business ethics
Transparency
Executive compensation
Whistleblower policy

Board members and the C-suite are being encouraged to initiate, monitor, and lead ESG strategies effectively and efficiently for better reporting capabilities. Similar to other corporate efforts, board oversight is needed to elevate ESG strategies to the center of all decisions made by a company.

Companies want to have personnel in place to navigate the unknown that exists around ESG. Each company will have a different approach to implementing and tracking ESG strategies and their overall impact. Governance is considered key to keeping ESG at the forefront of the company's operations while it continues to evolve.

Why companies should care

Despite the fact of gaining investor's trust and support, regulations are emerging around the world. As regulators continue to get involved, companies are noticing it is harder to avoid reporting on the matter. If companies defer implementation of ESG reporting, it could result in loss of customers, loss of investors, and legal consequences.

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> To have an effective and meaningful ESG strategy that makes a positive impact, companies must tailor their approach to their individual company. Entities must clearly define which ESG metrics are crucial to their operations.

ESG strategy and reporting varies widely between company and industry. Companies who have been effective in gaining public trust and reporting on ESG have done so through true integration with strong corporate management and board-backing. Integration, coupled with effective leadership, can ultimately drive an effective ESG landscape.

Regulations are unfolding as a way to keep companies accountable and more comparable. Investors, employees, and customers want to see action and want to see progress. Companies must fully commit to their ESG strategy to report on the matter efficiently and accurately, and regulators are wanting to provide investors with the comfort that some sort of credibility has been given in the companies' efforts.

II. The US Focus – Environmental

Within the United States, the majority of the rules, regulations, and SEC involvement are focused on environmental issues currently. Regulators see increased inconsistencies when it relates to climate and net zero initiative disclosures as compared to social or governance disclosures. Stakeholders are pushing to see progress against the claims that companies are making toward these areas.

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Social and governance metrics and initiatives are still important to an investor, so companies are including these areas within disclosures regardless if covered under the scope of the proposed SEC regulations.

Proposed SEC regulations

In March 2022, the Securities and Exchange Commission announced their new proposed regulations over ESG in an effort to formalize and create consistency across ESG climate-related disclosures within public companies' reports. With increased focus on ESG reporting, companies are starting to increase reporting on targets for carbon reduction or carbon neutrality. Currently, investors feel there is a lack of transparency in reporting on progress against these targets that are published. The SEC is hoping to give investors more insight into a company's ESG strategies while simultaneously standardizing the information to make it easier for investors to compare different companies' initiatives to one another.

> Although the proposed guidance remains in limbo, companies are beginning to implement changes within their organization using the proposed disclosures as a guide.

Originally, the proposed rules were to be effective by December 2022. The rules were set to be first applied to large, accelerated filers' fiscal year 2023 filings, which would be filed in 2024. However, due to the nature of the regulations and the high political arguments around the topic, the SEC has seen over a year's worth of delays in finalizing the rules.

Proposed SEC disclosures

The proposed SEC guidance includes both quantitative and qualitative disclosures that would be required for U.S. public companies to disclose within their annual filings or registration statements. Although the focus is on climate-related risks, the disclosures involve how the board and management are overseeing the entire process as well.

The majority of the required disclosures revolve around non-financial statement disclosures, but companies will be required to quantify the impact of their material climate-related risks within their annual filings and registration statements. These impacts could be beneficial or harmful.

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When determining if a climate-related risk has a material impact to the business, companies should utilize their standard process of determining materiality. This includes both a quantitative and qualitative analysis.

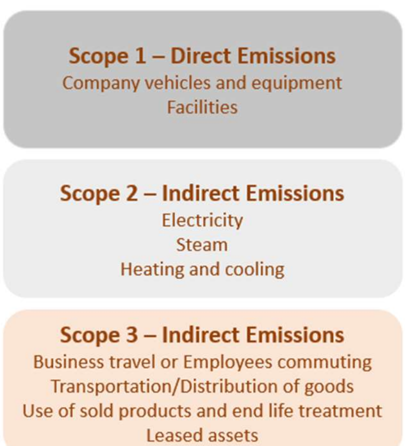
Outside of the financial statements, companies should be prepared to qualitatively disclose material climate-related risks, which includes both transition and physical risks, and how the company believes this could materially impact the current business and its future outlook.

Transition risks are any risks that a company faces when trying to reduce its carbon emissions whereas physical risks are those that occur due to the change in climate. Transition risks occur within the following categories: regulatory, market, and technology. Examples of transition risks include an increase in policy or legal action, customer behavior changes, interruptions in supply chain, and many more.

The qualitative disclosures also revolve around the process of identifying the risks, what target goals have been set, how the company plans to reach the goal, and if any progress has been achieved towards obtaining the goal. In addition to the quantitative impact included within the financial statements, the other main quantitative disclosures that companies are required to include are their greenhouse gas emissions.

GHG emissions disclosures

In the proposed rule, greenhouse gas emissions will be required to be disclosed within a company's annual report and any registration statements. Companies must present both their direct and indirect emissions for all years reported in the financial statements. To contribute towards consistency and standardization, the SEC's proposed GHG disclosure is broken into three categories – Scope 1 through Scope 3.



Scope 1 emissions are direct GHG emissions that occur from operations that are either owned or controlled by the company. Both Scope 2 and Scope 3 are indirect emissions, but Scope 2 emissions result from a company's purchased or acquired electricity and other forms of energy, whereas Scope 3 emissions are indirect emissions that occur within a company's upstream or downstream supply chain.

Scope 3 is the most inclusive category for greenhouse gas emissions that can occur from a company, which means it is also the most complex to gather data around. In order to reduce Scope 3 emissions, a company must evaluate the overall value chain of the goods or services that are provided. During the initial years of the proposed guidance being initiated, Scope 3 disclosures are only required by public companies if material or if the company has already set a target that includes Scope 3 emissions.

Assurance requirements

Similar to other SEC guidance, ESG disclosures will be subject to obtaining assurance by a third-party provider, and companies will have a transition period to improve the disclosures. During the first effective year of including the non-financial ESG disclosures, companies are not required to obtain assurance. However, large accelerated and accelerated companies must obtain limited assurance over their Scope 1 and Scope 2 disclosures during the second year's filing and reasonable assurance two years after that. Non-accelerated filers and smaller reporting companies are exempt from obtaining either limited or reasonable assurance. However, financial statement disclosures included in the footnotes of annual filings or registration statements, are subject to existing financial statement audit requirements.

The differences between limited and reasonable assurance revolve around amount of evidence, cost, and the testing method. Limited assurance is defined as negative assurance, meaning auditors are not aware of any material misstatements existing within the report based on the resources available to them. Reasonable assurance is defined as a high but not absolute level of assurance that the report is free of material misstatement.

Limited assurance results in less testing in scope whether around controls or financial metrics; sufficient but limited evidence gathered through a paper trail; and lower assurance costs compared to reasonable assurance. However, companies should know that controls and metrics are still tested, but instead of evaluating the source of the data, limited assurance tends to be focused on what information is readily available.

Many U.S. public companies have voluntarily started obtaining some type of assurance over their ESG disclosures in an effort to verify the existing issues within their ESG reporting capabilities.

Other US regulations surfacing

Even though the SEC regulations are not yet required, other U.S. regulators are joining the conversation on how to enforce ESG requirements. In October 2023, the state of California's legislation passed and signed into law two senate bills, SB 253 and SB 261, around climate policies. California is the first state to finalize its laws, but it is believed that many other states will follow suit in the upcoming years.

The California Climate Corporate Data Accountability Act, otherwise known as SB 253, requires any public or private company that does business in the state of California and reports a certain threshold of revenues to publicly disclose its Scope 1, 2, and 3 emissions. Companies that have total annual revenues of $1 billion or more and do business in California will be impacted by this new bill, and they could face up to $500,000 of fines per reporting year if they fail to comply. In order to meet the requirements within SB 253, a business must disclose and obtain limited assurance around Scope 1 and Scope 2 emissions by 2026. The exact date has yet to be determined by the state board. Scope 3 is required by 2027.

The California Climate-Related Financial Risk Act or SB 261 enforces businesses to disclose their exposure to both physical and transition climate risks. This act will end up impacting far more businesses than the SB 253 law as the threshold is lower. This law applies to companies who have total annual revenues of $500 million or more and perform business within the state of California. The effective date that companies must comply with is on or before January 1, 2026, but companies do not need to obtain assurance over this set of disclosures.

These new regulations have left many companies wondering what it truly means "to do business in California". The California Air Resources Board (CARB) will be responsible for defining this metric prior to the effective date.

The impacted

As more regulators join the climate issue discussion, an increased number of companies will be impacted regardless of size, filing status, or place of business. SEC regulations are directed towards large public corporations, but the state of California has opened it up to be inclusive of private companies. Smaller companies are also starting to focus on their ESG strategies due to pressures from large corporations pushing their own ESG initiatives through their supply chain. The SEC proposed climate-related disclosures aim to align with other global and EU regulations.

III. The International Focus – Sustainability

Overview

Environmental, social, and governance concerns have been discussed within European countries for years now. In terms of finalizing rules and getting regulations into place, Europe is ahead of the U.S.' efforts. While the U.S. regulators focus heavily on the climate-related risks, European regulators passed rules and standards that broadly speak to the overall sustainability of a business and its impacts on the world. There are many ESG frameworks and regulations published and used globally, but there are two regulations that are heavily focused on within foreign countries.

CSRD regulations

The European Union or "EU" created the Corporate Sustainability Reporting Directive (CSRD) effective January 2024. Prior to the creation of the CSRD, the Non-Financial Reporting Directive (NFRD) existed. The CSRD was created to build upon the foundation that NFRD laid and formalize a comprehensive approach to reporting on sustainability for more businesses that operate within the EU.

The new directive applies to companies beyond those that are listed on a European Union regulated market. If a U.S. company has an EU subsidiary that meets the threshold requirements and it has over €150 million in revenues from the EU, it could be subject to the CSRD regulations as well. However, large companies based in the EU that meet two of the three following criteria are considered in scope and will be subject to the CSRD:

CSRD reporting requirements will start in fiscal year 2024 and stretch into fiscal year 2028 depending on the type of company. The required disclosures encompass the entire array of sustainability topics and are detailed out within the twelve new European Sustainability Reporting Standards (ESRS). The framework includes standards in four categories: general cross-cutting standards (2), environmental standards (5), social standards (4), and governance standards (1).

IFRS regulations

As the CSRD's sole focus is on those companies impacting the European Union, the IFRS Foundation elected to form the International Sustainability Standards Board (ISSB) to help guide all global companies in executing sustainable strategies and standardizing global ESG disclosures.

In June 2023, the ISSB issued its first two sustainability standards, IFRS S1: *General Requirements for Disclosure of Sustainability-related Financial Information* and IFRS S2: *Climate-related Disclosures.* Both IFRS S1 and IFRS S2 are effective for annual reports beginning on or after January 1, 2024. The structure of the two standards appears to be a combination of the proposed SEC climate regulation and the CSRD requirements. The ISSB designed the two standards to be applied together.

Unlike the proposed SEC regulators and the CSRD, the ISSB lacks the authority to require businesses to apply the IFRS S1 and IFRS S2 standards as these standards are different from being IFRS compliance. Mandatory inclusion of IFRS S1 and IFRS S2 standards depends on each jurisdiction and country that the individual business operates in.

IV. Implementation

Now that regulators are either enforcing or about to enforce ESG requirements among a variety of companies, businesses must begin the process of thoroughly implementing their full ESG strategy into their operations, but many companies struggle to know where to start or how to do it effectively.

Identifying ESG's impact on your company

Before a company can think about the reporting disclosures needed or ideal targets to hit, companies must start by establishing an ESG strategy.

Every industry and business will be different, so it is important that each strategy, target, and process be tailored to how the company operates as a whole and their corporate goals. Some will have more of a social impact while others will be focused on climate issues. Strategies should incorporate input from regulatory compliance, stakeholders, and key business goals in order to build a roadmap for ESG implementation and targets.

Gap analysis

In order to implement ESG reporting strategies efficiently and effectively, companies must initially conduct some gap analyses. First, a company should analyze what regulations are becoming effective in the near future and determine if and when it applies to their individual entity. Once that is determined, companies must then compare their current data capabilities versus what they will need in order to meet the ESG regulatory reporting requirements that apply to them.

The capability to gather data completely and accurately around ESG reporting is considered a common gap area that exists within businesses. Many of the ESG disclosure requirements revolve around data that was not previously collected in the past as it was not necessary for operations. Companies will also need to assess their current inventory of technology during their analysis to see if it can assist with gathering ESG data or if they need to invest in additional technology that can be better utilized for the reporting requirements. Entities will likely need to be prepared for limited assurance in the interim and reasonable assurance requirements that will arise in the future.

After a company addresses its existing data gaps, another gap analysis should occur around the company's controls. Management must determine if current financial and operating controls can be utilized over ESG reporting as well. As there are certain ESG disclosure requirements around a company's financial statement impact, these new disclosures, especially for a public entity, will be subject to their auditor's internal control financial reporting testing. Therefore, a company must address any existing control gaps early on in the implementation strategy.

Controls over ESG

Due to the highly prioritized efforts around ESG reporting, organizations like the Committee of Sponsoring Organizations of the Treadway Commission (COSO) have released their thoughts on how to implement effective internal controls over ESG within a company. The report was released in March 2023, and it was written to show how companies can leverage the COSO Framework to establish an integrated system of internal controls over sustainability reporting (ICSR).

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Designing and implementing effective ESG controls will be one of the biggest challenges for companies to overcome. It will involve years of monitoring and improving, so companies must keep the long-term goals of ESG reporting in mind when developing controls.

The overall approach to implementing ICSRs is through the same five components as detailed within COSO. Companies must use their knowledge of the COSO Framework as a starting point to designing new controls around ESG. The ICSR report mentions three primary categories that are inherently different between typical controls and ESG controls. The first difference is that ESG frameworks may have varying views on the concepts of control or influence. Secondly, ESG reporting disclosures are generally more qualitative in nature compared to those in financial reporting. The third inherent difference is that ESG initiatives are typically focused on the future whereas annual filings disclosure historical results.

While the differences between ESG and typical controls should be considered when building out internal controls over ESG processes, management could use a similar approach to both. This includes utilizing a standard control implementation framework which includes four phases: assess, design, implement and monitor.

Primary focus for 2024

Although challenges exist and best practices are hard to find, the focus for companies in the next year, regardless of size and filing, must start the process of getting ESG strategies implemented. It will take time and many resources to completely gather the data needed to form the disclosures required. To get started, companies should prioritize three areas to improve and guide their 2024 ESG initiatives:

ESG regulatory compliance

↓

Assess risk and design internal controls over ESG

↓

Improve data capabilities around ESG

If companies are able to address these areas during the next fiscal year, they will be more likely to produce complete and accurate ESG disclosures that investors can rely on.

ABOUT US

TBH Consulting provides accounting and financial reporting services. We deliver Big 4 level of experience to our clients at competitive rates. We can mobilize the right resources at the right time to meet our clients' needs, whether such clients are Fortune 500, middle-market public companies or pre-IPO companies.

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