3 ATTRIBUTES OF ESG REPORTING

That Differ from Financial Reporting

A White Paper by

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MARCH 2021

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INTRODUCTION

The author suggests there are three core attributes of sustainability reporting that differ from financial reporting and disclosures.

1) Control and Influence
2) Quantitative and Qualitative
3) Retrospective and Prospective

Accountants, internal auditors, and assurance providers and others with experience in financial reporting and disclosures are becoming more involved in ESG reporting[1] and disclosures. There are already professionals who have involved in sustainability programs, reporting and reviews as they have evolved. Understanding these can help bridge the gap. It can also improve the effectiveness and efficiency of organization's governance, strategy, risk management – as well as financial performance and positive impact in non-financial areas.

SEC: The Power of a Proposal

ESG / Sustainability reporting and disclosures took another giant step with SEC's proposed rule on climate-related disclosures[1]. This is the latest in a long line of sustainability content originating in voluntary public reporting, and migrating towards reporting and disclosures to the capital markets – SASB, IIRC, TCFD, etc. With formation of the International Sustainability Standards Board (ISSB), the publication of ISSB prototypes, the EU taxonomy – it won't be the last.

THE ATTRIBUTES

Attribute #1: Control and Influence

ESG reporting extends beyond what organizations control, and into what organizations can influence.

Organizations have extended requirements for environmental and quality management systems into their supply chains for over two decades. Major auto makers required companies in their supply chain to obtain ISO 9001 and ISO 14001 certifications in the 1990s. The 2015 update to ISO 14001 emphasized the life cycle approach to environmental management, including supply chain and value chain.

Conflict minerals laws (Dodd-Frank in the U.S., other laws abroad) require companies to obtain data from supply chains. The objective of these laws is to influence suppliers to procure critical minerals from sources that have followed internationally accepted standards for due diligence. Modern slavery laws require companies to perform due diligence in their supply chain; the UK Modern Slavery Act

[1] "Sustainability" and "ESG" (Environmental, Social and Governance" are similar terms, and often used interchangeably. "ESG" is used from here on.

requires public reporting. These laws are intended to incite companies to influence their supply chain to ensure that these human rights abuses do not exist in their supply chain. Top performing companies can pursue other "downstream" objectives, achieving competitive advantage with their customers and business partners.

The SEC proposed rule on climate-related financial disclosures begins with Greenhouse gas (GHG) emissions - a proximal contributor to climate change. Organizations can control some GHG emissions – but they can influence much more. For example, organizations can request (or insist) that landlords purchase power from renewable sources. They can specify lower-carbon goods or services in their supply chain. They can change the design of products or packaging. They are expected to influence GHG emissions, and report how they have done so, and the associated improvements.

Attribute #2: Quantitative and Qualitative

ESG reporting includes quantitative information, as financial reporting does. ESG reporting includes metrics associated with labor force (board, executive and management team by gender or other attribute; relative compensation by those metrics, etc.). It can include data on water withdrawal by source, water usage, and safety statistics. It also includes GHG emissions inventories. Scope 1 and Scope 2 GHG emissions are the standard initial expectations. For most companies, Scope 3 emissions comprise the largest segment of overall GHG emissions; companies often report some categories of Scope 3 emissions as their programs mature.

ESG reporting and disclosures also include an abundance of narrative. The qualitative narrative can stand on its own, or it can provide context to quantitative data. What is the company's philosophy and approach on key topics? What are the company's efforts to improve workforce diversity and inclusion? How are they funded, are they working, and how does the company know? For the water withdrawn and used in company operations, how much of this is in water-stressed areas? How has the company engaged with stakeholders to safeguard sufficient amount and quality of water for the community? Is wastewater used (or usable) for other purposes – irrigation, groundwater recharge, etc.?

Most of the proposed requirements are narrative in the SEC's proposed rule on climate change disclosures. They involve governance, strategy, and risk management (see box), and go to the heart of the business.

SEC Proposed Rule on Climate Related Disclosures: Sample Disclosures

- What is the process for identifying, assessing and managing climate-related risks? Are these processes integrated into overall risk management?
- How have/ will climate-related risks affect strategy, business model, and outlook?
- If you use an internal carbon price, how did you set it?
- If you have adopted a transition plan as part of risk management, describe the plan.
- If you use scenario analysis to assess the resilience of business strategy, describe the scenarios, parameters, assumptions, choices,

Attribute #3: Retrospective and Prospective

Financial reporting is often described as a snapshot. It is a concise retrospective look at the prior reporting period (income statement), and a snapshot of the organization's condition at a point in time (balance sheet). Companies include forward-looking content in supporting notes, in management discussion and analysis – but it all begins with the snapshot.

ESG reporting tilts more heavily towards prospective content. Stakeholders are evaluating not only the snapshot, but what companies have committed to doing – and how they are performing compared to previously-announced commitments or targets.

Safety was an early example. It is a noble and commendable to aim for zero safety injuries and incidents. But everybody is human, and perfection is not attainable. If any injury ruins the achievement of a goal, this can have the unintended effect of suppressing complete and accurate reporting. Companies learned to set goals that were ambitious and achievable – and to provide resources and controls to pursue them.

Companies have set other ESG goals (diversity in work force, water use, etc.), and reported on progress over multiple years. Companies began reporting their [narrative] strategies to achieve ESG goals, such as reformulating products, requiring suppliers to improve performance, or reducing energy use. These were often for public relations, industry awards, or to meet stakeholder requests.

Demand for ESG reporting and disclosures from the capital markets – including forward looking narratives, commitments, and goals – has changed everything. Complete, accurate ESG reporting and meaningful narrative have more financial implications when trillions of dollars (and Euros) are seeking high ESG performing investment opportunities. Glittering generalities can be recognized as marketing puffery. Ambitious narrative and projections in a Form 10-K with poor planning, few resources, no strategy, and little real intent might start to look like securities fraud.

BRIDGING THE GAP

These attributes have been hiding in plain sight. Even the SEC's proposed rule on climate related financial disclosures isn't groundbreaking. It bears the fingerprints of the ISSB prototype on climate related disclosures, the TCFD, and SASB before them. SASB, in turn, insisted from the outset that sustainability reporting and disclosure standards required no new law. SASB simply applied sustainability knowledge, rigor and a public process to existing law – including the definition of "materiality" as set by the U.S. Supreme Court.

All parties can contribute to more effective, efficient ESG reporting and disclosures.

- **Internal Auditors, Management Accountants:** As an ESG specialist working for many CPAs, I've seen accountants attempt to apply accounting rules directly to ESG. Sometimes it works, sometimes it doesn't. Learning more about ESG attributes, context and drivers (including enlisting the support of specialists) accelerates progress.

- **ESG Professionals:** ESG professionals are passionate about the topic, and seeking change. Most have grown weary of pretty photos and happy talk as a proxy for ESG performance and change. The major reporting frameworks have evolved substantially over the last decade, so ESG professionals are on their way. The GHG protocol is, at its heart, an accounting rule. The expectations and stakes in reporting and making to disclosures are a different realm from voluntary reporting. SASB study guides, learning and credentials offered by the Institute of Internal Auditors, and other business-oriented skills can help learn the lingo of the accountants and (internal and external) auditors.

- **Second Line Auditors:** Many companies have auditing functions for higher-risk areas: environmental, safety, quality, IT[2], etc. Some of these programs have remained largely unchanged for years. Yet these auditors have organizational and subject matter knowledge that could add value to the changing world of ESG risk. Second line auditors would do well to step up. Internal Audit and accountants can use them to accelerate their own journey.

[2] These "internal audit" programs are authorized by company Management, and should not be confused with Internal Audit function, which is authorized by – and reports to – the Board. The audit programs discussed here are sometimes referred to as "second line" audit programs, contrasted to Internal Audit as the "third line." See The IIA's Three Lines Model: An update of the Three Lines of Defense.

Douglas Hileman, FSA, CRMA, CPEA helps clients achieve more success with ESG compliance, risk management, reporting, and auditing. He has written sustainability reports, drafted disclosures to capital markets, and supported Clients' development & improvement of internal controls. He has designed, evaluated, and conducted quality assurance reviews for EHS/ sustainability audit programs.

His experience includes operational and corporate compliance, environmental/ safety auditing, Internal Audit, supporting financial audits, and external assurance (Dodd-Frank Conflict Minerals). He served on the Volkswagen Monitor team for three years. He has experience in an array of industry sectors: automotive, chemicals, energy, financial services, government, hospitality, manufacturing, pharmaceuticals, professional services, transportation and logistics, utilities.

He is active in the Institute of Internal Auditors. He co-presented a four-hour pre-conference workshop on ESG reporting at the 2022 General Audit Management (GAM) conference. He was also featured in a track session "Managing the ESG Reporting Risk Landscape." He was co-chair of programming for the 2019 IIA International Conference. He has presented and led ESG sessions – including on climate change risk – for over a dozen years. His firm serves clients nationwide from Los Angeles.

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