

Sustainability in a New Era: Complicated Dynamics to Add Value



Presented by
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at
2025 Compliance Week National Conference
Washington, DC
April 30, 2025

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1

Objectives & Agenda

Objectives

- Refresh on Sustainability/ ESG drivers, purpose
- Empower Compliance professionals to reset and add value

Agenda

- 1) Recap and Reset
- 2) Compliance, Risk
- 3) Reporting
- 4) Internal Controls over Sustainability Reporting
- 5) Data: Reliability; Analytics; Value

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2



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Sustainability: Recap and Reset

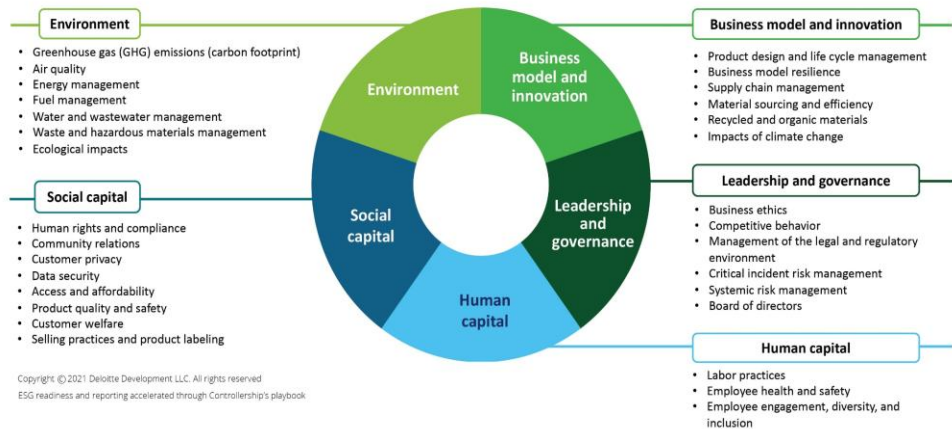
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ESG: Deloitte Model (2021)



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ESG: Another Model



- “Sustainability” encompasses ‘all things non-financial’.
- “ESG” is one way to begin organizing a wide array of non-financial issues in a taxonomy that enables meaningful strategy, program development, performance measurement, communications, and reporting.
- Aspects of Sustainability may pose financial risk; they may have financial impact. Either/ both may be “significant” or “material” (both terms are defined).
- This depends on sector/ industry, organizational strategy, and other factors.

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Sustainability: What's Out, What Hasn't Changed

What's Out	What Hasn't Changed
Diversity, Equity and Inclusion	The need to attract and retain talent.
Extent of emphasis on Sustainability topics in investment decisions	Identifying and meeting compliance requirements Identifying and mitigating significant risks Leveraging opportunities Monitoring effectiveness and efficiencies of actions taken
Exclusive focus on financial materiality Ignoring stakeholder input regarding non-financial impacts. (EU)	Continued focus on financial materiality, for primary users of general-purpose financial statements. Mechanisms to engage with stakeholders (hot lines, etc.)

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Sustainability: DHC Perspectives

- Sustainability is a state; a desired condition.
- “ESG” is a taxonomy, not an expectation to be everything to everybody.
- Sustainability is no one thing. It differs by sector, geography, organization, and objectives.
- There's Climate, and there's everything else.
- Sustainability poses risks and opportunities. To whom/ for whom?
- Sustainability is dynamic – always has been.

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Compliance: It Creeps in on Little Cat Feet (Thank you, Robert Frost.)

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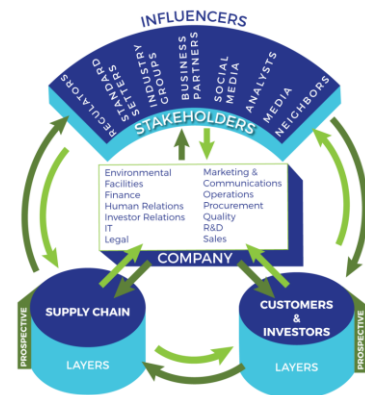
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Sustainability Compliance: Channels

- Legal and regulatory
 - Enforceable by sovereign entity
 - Legal/ contractual
 - Enforceable by business partner
- Industry standards, frameworks, codes of conduct
- Voluntary obligations



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Laws, Regulations, Standards, Drivers US – Federal (partial)

- Traditional: environmental (EPA); safety (OSHA); wages (Dept. of Labor)
- SEC: disclosures on material topics in Form 10-K
- Consumer Product Safety Commission
- Federal Acquisition Regulation (includes question on greenhouse gas (GHG) emissions inventory)
- Uyghur Forced Labor Protection Act

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State Laws: Example California Transparency in Supply Chain Act

Applies to

- Retail sellers or manufacturers
- Doing business in the state of California
- Global gross receipts >\$100 MM

Requirements

- Verification of supply chains re: human trafficking and slavery
- Audit of suppliers
- Direct suppliers must certify materials
- Internal accountability standards for failing to meet requirements
- Provide training

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Laws, Regulations, Standards, Drivers: European Union

Corporate Sustainability Reporting Directive/ EU Sustainability Reporting Standard

- Mandatory reporting and disclosures concurrent with financials
- Applies double materiality
- First reporting period is CY 2025 (“Wave 1”)
- Will require [limited] assurance

Also:

- Green Taxonomy
- Green Finance
- Sustainability Due Diligence (supply chain)
- Cross-Border Adjustment Mechanism (CBAM)

Omnibus Proposals
include:
Delay for smaller/
medium companies;
Still assurance, but
reasonable only

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Other Drivers: B2B

- Contractual requirements
- Supply chain due diligence
- Verification / audits
- Commitment for future improvements
- Periodic [B2B] reporting



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Sustainability Compliance: Voluntary Obligations

Traditional

- ISO certifications (9001, 14001)
- Energy Star
- Code of Conduct, general company commitments



More Recent

- B Corp; other credentials and certificates
- Best Places (to work, gender equity, most energy efficient, etc.)
- Sector/ Industry standards, frameworks
- Paris Climate Accords (2016)
- Goals and targets



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Sustainability Compliance & Risk: DHC Perspectives

- Compliance arises in ways obvious (laws, regulations) and not obvious (contracts).
- The array of requirements imposed by others may not be consistent with each other.
- Voluntary obligations should be considered “compliance”. After all, these commitments are rarely made without some benefit to the organization.
- The pause in new laws & regulations is a good opportunity to catch up, improving efficiencies and effectiveness.

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Reporting: What's Going On?

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Selected Standards, Frameworks and References

Global Reporting Initiative (GRI)	SEC Regulation S-K Guidance	Science-Based Targets Initiative (SBTi)	COSO Internal Controls over Sustainability Reporting (ICSR)
Greenhouse Gas (GHG) Protocol	Sustainability Accounting Standards Board (SASB)	Task Force for Nature-Related Financial Disclosures (TNFD)	Calif. Climate Disclosure Laws (SB 253, SB 261)
Carbon Disclosure Project (CDP) – Climate	Task Force for Climate-Related Financial Disclosures (TCFD)	International Sustainability Standards Board (ISSB)	Canadian Sustainability Disclosure standards (CSDS)
Carbon Disclosure Project (CDP) - Water	UN Sustainable Development Goals	EU's Corp. Sustainability Reporting Directive (CSRD)	SEC Climate Disclosure Rule

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Observations on Sustainability Reporting

- Demand for reporting has outpaced the ability to report.
- Growing calls for assurance.

Sustainability reporting differs from financial reporting:
3 attributes

Original white paper at
www.douglashileman.com

3 Attributes of ESG Reporting / Sustainability Reporting



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Sustainability Reporting Different Channels → Different Data Needs

Data Needs : Examples

- How much water do we use? Where does it come from? Do our operations (or supply chain) impact scarce water resources?
- How much waste from our operations is recycled?
- How much of our raw materials has been recycled?
- What is the GHG emissions (in CO₂e) inventory of the company?
- How much CO₂e in the products you sell to Customer X?
- How much CO₂e at the location in [country, state, or location]?
- What % of suppliers have code of ethics that meet or exceed our requirements? By number? By spend?
- Do suppliers pay fair wages?
- What is our progress towards goals?
- How can we improve ratings with analysts?
- How many customer requests do we get? Do we respond in time?
- What are safeguards to preserve IP?
- How do we know data is accurate and supportable?
- Is data reported via different channels the same? If not, why not?

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Sustainability Reporting: DHC Perspectives

- Demand for reporting has outpaced the development of systems & controls to produce content for reporting.
- Once you begin reporting on a topic, it's hard to stop. But not impossible.
- Preparers and users are not yet fully aligned. Users could help their cause with more direct feedback.
- B2B reporting is eating everybody's lunch. Many don't know it.
- Double Materiality Assessments (DMAs) are different. Consultants can help, but you must own the results – and everything that's done with it.
- Assurance [limited] is coming for EU reporting.

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Climate: With no more SEC rule, we can stop – right?

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Climate: What's Out, What Hasn't Changed

What's Out	What Hasn't Changed
<u>U.S. SEC Climate Disclosure Rule</u> Regulation S-K <ul style="list-style-type: none"> Governance, Strategy, Risk Metrics, and Targets (Optional) 	<ul style="list-style-type: none"> ISSB S-2: Global accounting standard TCFD: Voluntary climate disclosure framework California climate laws (SB 253, SB 261) CDP [formerly Carbon Disclosure Project]; portal for climate & other disclosures Science-Based Targets Initiative (SBTi) Use of climate-related disclosures for investments, supplier decisions B2B requests & info exchange
Regulation S-X <ul style="list-style-type: none"> Changes in financials (assets, liabilities, revenues, costs) of >5%, and explanations 	<ul style="list-style-type: none"> Occurrences of "extreme weather events or other natural conditions." Impacts on asset values, revenues, costs – from risks <i>or opportunities</i>

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Climate: International Sustainability Standards Board (ISSB) S-2

Launch Date	11/3/2021
Objectives	Establish global guidelines for disclosure regarding Climate risks and opportunities.
Intended Users	Primary users of general-purpose financial statements.
Summary	ISSB is part of IFRS Foundation. Merger of SASB, IIRC. Continues approach of legacy SASB. "Single" materiality. S-1 (General) and S-2 (Climate) published 6/26/2023.
Where/ How Used Now	Adoption in EU for disclosure in financial filings. Incorporated TCFD, adding more: granularity, disclosures. Requires disclosure of Scope 3 GHG emissions.
Website	https://www.ifrs.org/groups/international-sustainability-standards-board/

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Climate: California Climate Disclosure Laws (SB 253 and SB 261)

Launch Date	10/9/2023
Objectives	If "doing business in California"; reference to tax code (likely). SB 253: Report GHG <u>emissions</u> for companies >\$1 billion in revenues. [quantitative] SB 261: Report material climate-related financial risk aligned with TCFD. >\$500 million in revenues. [narrative]
Intended Users	Broad range of stakeholders.
Summary	Requirements align with TCFD. CARB must develop regs; could be delayed. Also applies to private companies. CDP could be disclosure portal.
Where/ How Used Now	Motivation for companies to begin or improve climate-related efforts, regardless of SEC action/ inaction. Non-public entities are paying more attention. New York, Illinois considering similar state laws.
Website	https://leginfo.legislature.ca.gov/

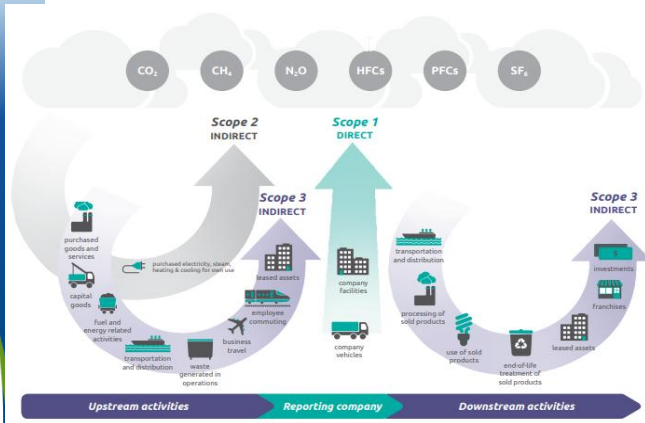
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GHG Protocol



Scope 1 = Direct emissions, from combustion
Scope 2 = Indirect emissions from purchase of energy
Scope 3 = All other indirect

Scope 3: Value Chain
Upstream: 8 categories
Downstream: 7 categories

GHG Protocol Corporate Standard
GHG Protocol Scope 2 Guidance
GHG Protocol Scope 3 Guidance
These and more at www.ghgprotocol.org

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Climate: DHC Perspectives

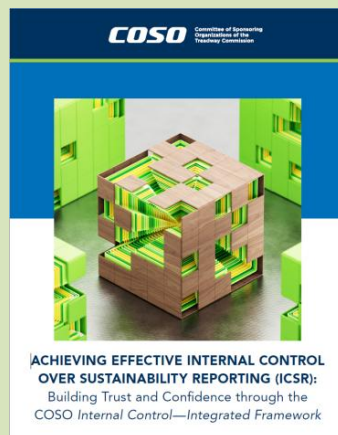
- Withdrawal of SEC climate disclosure rule provides relief to publicly-traded companies in the U.S. Most provisions will probably be imposed via other channels.
- Perhaps the biggest relief is re: Regulation S-X (5% change on financial statement line items). But the variations could still be there. Despite the relief from SEC, wouldn't it help to know that?
- If you sell anything to anybody, you're someone else's Scope 3.
- Many vendors are offering solutions for calculating GHG emissions inventories. There's not a SOC 2 report for counterpart for this.
- Mandatory assurance will probably hit GHG emissions inventory.

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COSO: Achieving Effective Internal Controls over Sustainability Reporting (ICSR)

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COSO ICSR



- COSO ICIF is standard for internal controls over financial reporting (ICFR).
- "Reporting" isn't limited to financial
- Supplemental guidance released March 2023
- Douglas Hileman is an author



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COSO Internal Controls over Sustainability Reporting (ICSR)

Launch Date	March 2023
Objectives	Encourage parties to leverage COSO ICIF for Sustainability reporting.
Intended Users	Parties who know "internal controls" (Acct'g., Audit, Finance) Parties who don't (Environmental, Ops, Procurement, Sustainability, etc.)
Summary	Supplemental guidance is approachable for all. Helps companies develop or enhance processes, procedures, data management. See "3 Attributes" section and DHC white paper.
Where/ How Used Now	In-house: companies building or improving controls for content that will be externally reporting. Also to improve effectiveness and efficiencies. External: basis for assurance criteria.
Website	www.coso.org www.douglashileman.com

Douglas Hileman is an author of the COSO ICSR document.

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30

Component I: Control Environment



Principles	Examples of Risks
<ol style="list-style-type: none"> 1. Commitment to integrity and ethical values 2. Independent Board of Directors oversight 3. Structure, reporting lines, authorities, responsibilities. 4. Attract, develop and retain competent people. 5. People held accountable for internal control. 	<ul style="list-style-type: none"> • Employees interpret weaker Code of Conduct/ commitments as increased opportunity and rationalization to commit fraud. • Sustainability programs are abruptly eliminated, leaving employees, customers unserved. • Reduced efforts on non-financial topics known to be material to the industry reduces financial prospects, increases capital costs. • Downsized Sustainability programs are assigned to individuals without competencies to fulfill obligations. • Board and Management assume each other has non-financial issues under control. • Employees, contractors, business partners fear calling hotlines. Open season for waste, fraud, and abuse.

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Sustainability Controls: Examples

- Policy(ies): climate; water; human rights
- RACI Matrix assigning roles, responsibilities
- Sustainability provisions in supplier contracts
- Forms to collect electricity use
- Meters to measure water use
- Excel files used to perform calculations
- Commercial solutions for data collection, analysis, compilation
- Cross-functional teams
- Quality control, “four eyes” principle
- Second line audits



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Sustainability Controls: DHC Perspectives

- ~90% of market value of S&P 500 is attributable to intangible assets, including IP, brand reputation, customer relationships and goodwill. All that “soft stuff.”
- Non-financial (aka “Sustainability”) activities are necessary for organizations to function and create value.
- COSO ICSR is an excellent starting point to design, tailor, and implement controls.
- Leverage cross-functional teams and specialist knowledge to identify opportunities: reduce costs, enhance product & service offerings, etc.
- Assurance providers will likely begin with COSO; the ICSR guidance can reduce burden/ help achieve success.
- If you think it’s a costly burden, you’re right. If you think it’s an opportunity, you’re also right. Pick one.

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**Data Analytics:
Connecting the Sustainability Dots.
Which ones, and How?**

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34

Data Reliability

Qualitative/ Narrative

- Publicly: tailored to risks and needs of stakeholders
- B2B: Stakeholders rely on processes and commitments

Quantitative

- Comparability with other companies
- Comparability – year-on-year
- Basis for internal analysis, communications
- Support for allocation of capital and resources

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Data & Analytics Example: Scope 2 GHG Emissions

Information Obtained	Data Calculated or Reported	Potential Learnings
<ul style="list-style-type: none"> • Locations, and sq ft leased • No. of employees, by location • WFH employees, by location • Electricity used in leased space, by month • Costs of electricity from building manager. • Frequency, costs for after-hours cooling • Cost structure for kWh (tiers, Time-of-Use) • Costs for employee & guest EV charger use • Can purchase renewable electricity from utility 	<p><u>For Reporting</u> Scope 2 GHG Emissions, location-based (by state) and market-based (from utility) Emissions intensity (employees).</p> <p><u>Other Data Analytics</u> Cost of electricity/ 1,000 sq ft Variances between base kWh cost and actual location costs Locations with highest off-hours use (and cost) Other intensity basis (sq ft, sales) Locations and causes of seasonal spikes in use, costs</p>	<ul style="list-style-type: none"> • A few employees use the most after-hours HVAC, at significant cost • Providing EV charging to employees could be a taxable benefit. • Bldg. mgrs. should reconfigure HVAC systems. • Submetering could reduce costs, vs. bldg. mgr. • Some seasonal WFH could reduce costs & emissions. • Locations X, Y, Z are most cost-effective to reduce GHG emissions via renewables.

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Data Analysis: DHC Perspectives

- Sustainable business information includes narrative (qualitative) and quantitative information. The two should align – no greenwash (or fraud), please.
- Organizations have data relevant for Sustainability, but don't recognize or manage it as such.
- Creative data analysis can reduce risk, add value, and identify [financial and non-financial] opportunities.
- IT and Sustainability specialist input make data analytics more effective.

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37

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Doug helps clients with compliance, risk, processes and controls, audits, and assurance readiness in the ESG and climate space. He often provides ESG subject matter expertise to law firms, accounting firms, IT and management consultancies. He draws on 40+ years of experience in operations, corporate compliance, management consulting, internal audit and external assurance. He was the senior environmental management and environmental auditing specialist on the Volkswagen Monitor Team.

He is an author of COSO's "Achieving Effective Internal Controls over Sustainability Reporting (ICSR)", released to wide acclaim in March 2023.

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3. Reset

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4. 5 Roles for Internal Audit – and How

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40

