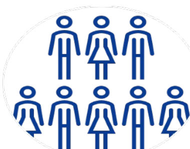
June 2023

CFGI

CAW CPE EVENT

BEYOND ACCOUNTING – BEYOND THE NUMBERS

Reporting Sustainability & ESG and Risk Management



Learning objectives

After completing this session, you should be able to:

- Understand the history of ESG reporting and the context in which ESG enters finance and accounting considerations

- Become familiar with the ESG reporting landscape as it appears today in terms of domestic requirements, international requirements and voluntary reporting

- Know relevant ESG-specific topics important for reporting and disclosure

- How to build an enduring ESG reporting structure through ERM/GRC

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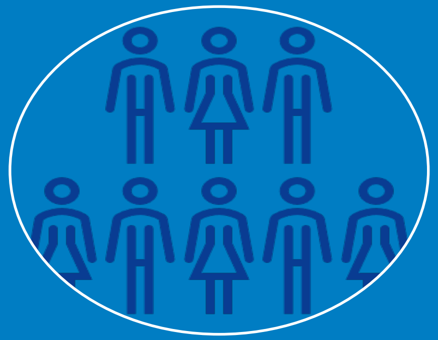
What is ESG and why does it matter?

ESG – environmental, social and governance is the crossroads where societal needs meet business opportunity to change the way companies develop strategy, drive performance, and report results.

Adopting ESG principles means that corporate strategy focuses on the three pillars of the environmental, social and governance.

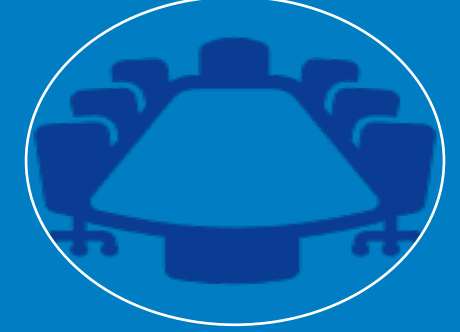
Environmental

Climate Change
Air and Water Quality
Carbon Emissions
Deforestation
Waste Management
Electronic Waste
Environmental Opportunities



Social

Human Capital
Labor Standards
Working Conditions
Diversity & Inclusion
Community Relations
Access to Healthcare
Access to Training



Governance

Board Structure
Executive Compensation
Business Ethics
Transparency
Tax Strategy
Protecting Shareholders
Political Lobbying
Cybersecurity

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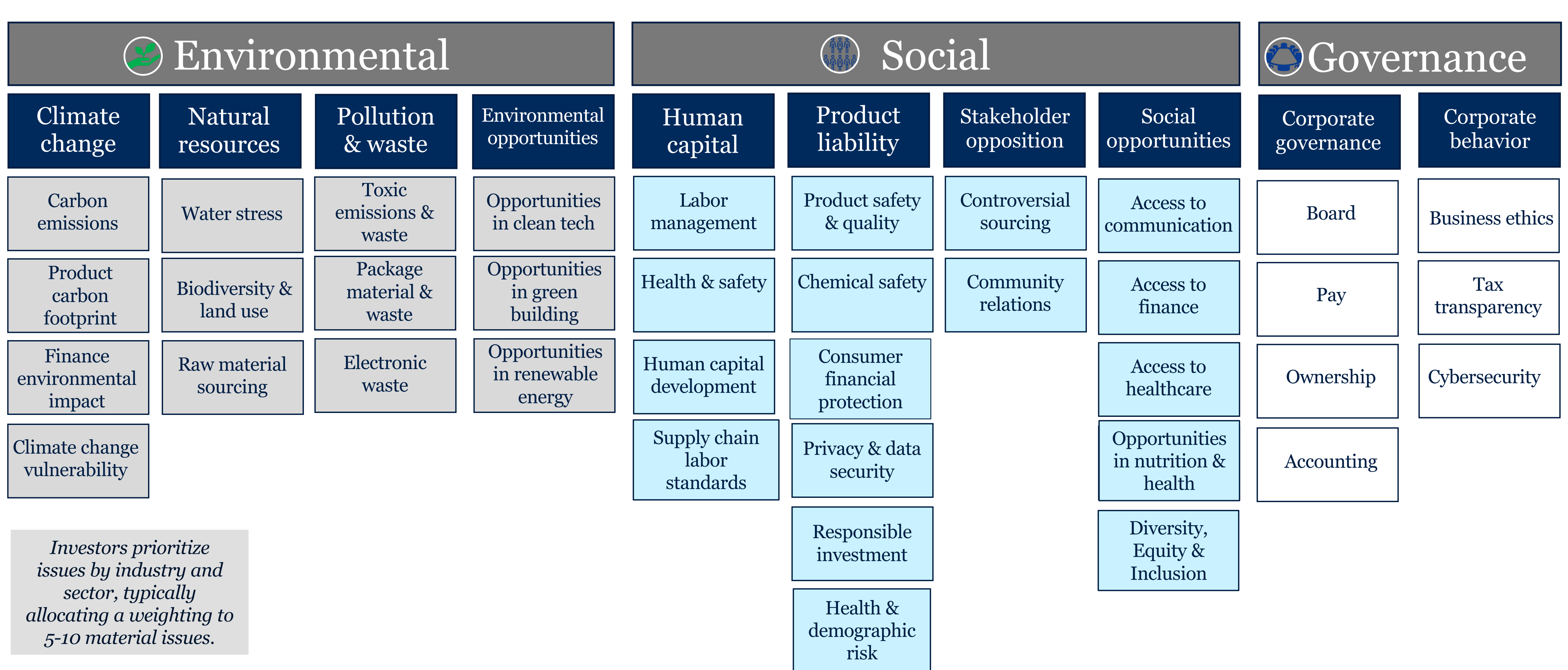
The three pillars of ESG

ESG is not just about climate change. It considers the impact to the entire eco-system surrounding business operations.



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ESG History & Background

- Sustainability Disclosure & Lacking or Inconsistent Information
- Corporate Social Responsibility (CSR)
- 1990s: The Rise of CSR Reporting at Major Corporations

Stakeholder Theory

"The decisions and actions of the businessman have a direct bearing on the quality of our lives and personalities. His decisions affect not only himself, his stockholders, his immediate workers, or his customers – they affect the lives and fortunes of us all."[1]

~Howard R. Bowen

vs.

Shareholder Theory

"There is one and only one social responsibility of business–to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

~ Milton Friedman

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ESG History & Background

Evolution of Financial & Sustainability Reporting

Accounting Principles Board (**APB**) created

Financial Accounting Standards Board (**FASB**) replaced APB

International Accounting Standards Board (**IASB**) established

IASB issued International Accounting Standards (**IAS**)

Global Reporting Initiative (**GRI**) was founded

International Financial Reporting Standards (**IFRS**) replaced IAS

Sustainability Accounting Standards Board (**SASB**) created

IFRS Foundation announced the creation of International Sustainability Standards Board (**ISSB**)

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Domestic Reporting: SEC Rulemaking

Pay Versus Performance Final Rule

- Issued August 25, 2022
- **Tabular disclosure** of specified executive compensation and financial performance measures for **the five most recently completed fiscal years**
  - Describe the relationship between:
    - Each financial performance measure included in the table & the compensation actually paid to the executive officers
    - The Company's TSR and that of its peer group
- List 3-7 of the most important financial performance measures
- Disclosure requirements in the proxy **effective for fiscal years ending on or after December 16, 2022**

Listing Standards for Recovery of Erroneously Awarded Compensation Final Rule

- Issued October 26, 2022
- Requires the SEC to direct the national securities exchanges and listing associations to establish **a "clawback policy"**
  - **Noncompliance by an issuer may trigger delisting**
- Each listed issuer must:
  - Adopt a clawback policy to recover incentive-based compensation **based on any misstated financial reporting measure** if the issuer is required to restate its issued financial statements
  - Provide certain compensation recovery policy disclosures
- Became **effective January 27, 2023**

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Comparison of "Big 3" Climate Disclosure Proposals

	SEC	ISSB	CSRD
Scope	• Proposed rule addresses climate-related risks • A rule addressing human capital is expected in the future	• Proposed standards address climate and other sustainability risks • Additional standards are expected in the future	• Proposed standards span across various ESG topics, including two dedicated to climate disclosures
Industry Standards	• Industry-specific disclosures are not required	• Industry-based climate metrics based on the SASB's standards would be required	• Sector-specific standards are in development
Location of Disclosures	• Regulation S-K disclosures included in separate Item in the annual report or registration statement • Regulation S-X disclosures included in financial statement footnote, which includes the impact of severe weather and transition-related activities	• Included as part of general-purpose financial reporting • No financial statement footnote disclosure would currently be required	• Included within a dedicated section of the management report • No financial statement footnote disclosure would be required

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Materiality

SEC Proposal

- Disclosure threshold based on financial materiality
- Threshold not applied consistently throughout proposal
  - A 1% bright-line threshold would be applied for financial statement footnote quantitative disclosures by line item
    - Ex. Severe weather impacts

ISSB Proposal

- Aligns with IFRS definition of materiality for financial standards
- Focuses on the primary users of the financial reporting information & how the info could reasonably be expected to affect their assessment of enterprise value
- Threshold applied to all disclosure requirements

CSRD

- Double Materiality - disclosure is material if it is material from an "impact" perspective, a financial perspective or a combo of both
  - Impact perspective – material if connected to actual impacts by the entity on people or the environment
  - Financial impact – material if has significant financial effects on the entity

A concept: dynamic materiality - what is immaterial to a company or industry today can become material tomorrow and vice versa

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Other Sustainability Reporting

TCFD - Taskforce on Climate-related Financial Disclosures

- Recommends information companies should disclose for stakeholders
- SEC's proposed rule, ISSB S1 & S2, and CSRD broadly align with this framework
- Comprised of 11 recommended disclosures structured around these four core operational themes:

EXAMPLES

Governance	Strategy	Risk Management	Metrics and Targets
Board's oversight of climate-related risks and opportunities	Climate-related risks & opportunities identified over the short, medium, & long term	The organization's processes for identifying & assessing climate-related risk	Metrics to assess climate-related risks & opportunities in line with its strategy & risk management process

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BUILD AN ENDURING SUSTAINABILITY & ESG REPORTING STRUCTURE THROUGH ERM/GRC

A Timeline....

World's biggest companies face $1 trillion in climate change risks

June 04 2019

- 215 biggest global companies report almost **US$1 trillion** at risk from climate impacts, with many likely to hit within the next **5 years**
- Companies report potential **US$250 billion in losses** due to the write-offs of **assets**
- Climate business opportunities calculated at **US$2.1 trillion,** nearly all of which are highly likely or virtually certain
- Potential value of sustainable business opportunities **almost 7x** the cost of realizing them (US$311bn in costs, US$2.1 trillion in opportunities)
- Financial companies forecast **US$1.2 trillion** in potential revenue from low emissions products & services
- Financial services industry represents almost 80% of the total potential financial impacts in the sample set
- Fossil fuels companies report more opportunities than risks from the low-carbon transition, raising questions about what they are reporting

Source: https://www.cdp.net/en/articles/media/worlds-biggest-companies-face-1-trillion-in-climate-change-risks

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Environmental, social and governance is the crossroads...

ESG is an **emerging priority** for executives and investors, both domestically and globally, and **across all industries**.

A company's sustainability strategy has natural alignment with a **Business Strategy** built by an ERM forward thinking entity. ESG **drives value** for both the business and its stakeholders, through:

- **Enhanced reputation** with customers, employees, investors, analysts
- **Increased resilience** to business disruptions caused by climate change and resource scarcity
- **Cost reduction** due to operational efficiency insights from data gathering and analysis
- Product **differentiation** and **increased market share** resulting from the study of social and environmental trends
- Fulfilling environmental and social responsibilities to **drive positive change** and be a force for good

Source: *ESG Wheel from FTSE Russell ESG Rating*

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Where to start?

Determine key internal stakeholders and readiness approach

Identify functions with a key role in the lifecycle of ESG financial reporting and disclosure readiness.
Are they engaged?

Is ESG readiness being **treated as an entity-level program** and subject to good project management?

Which **functional team(s)** will be the **stewards** of the program going forward?

Engage with your Compliance and Internal Audit functions!

Determine the scope and internal capabilities to support climate reporting

Determine the applicable regulation (SEC, CSRD, and ISSB).

Assess E, S, & G topics that are relevant to your industry and sector through a multi-stakeholder materiality assessment.

Assess climate-related risks of transition activities, changes in policy and legal context, and physical impact of climate change.

Choose standards and metrics

Align on standards and frameworks to use in reporting.

Conduct a gap assessment over current disclosures against expected disclosures. Compare to best practice, industry peers, and historical disclosure.

Bring different views to the table to better understand ESG data & metrics (e.g., capital markets investors, raters, etc.).

Link your ESG metrics and KPIs to your ERM program and strategy objectives.

Data Definition and Governance

Leverage existing Data Governance capabilities to managed ESG data.

Invest in technology to enhance the underlying infrastructure supporting your data and **use emerging technology** for **transforming** data management, monitoring, and reporting.

Embed **data quality controls** in data collection activities to address **Relevance**, **Objectivity**, **Measurability (Consistency in applying qualitative and quantitative methods), Completeness**, and **Accuracy**

Governance, Risks, and Controls Readiness

Determine if the current Governance, Risks, and Controls posture can address and contain new risks.

Key considerations include:

- Defining/redefining roles and responsibilities **(RACI)**
- Revising policies and procedures
- **Assessing and closing gaps in key talent**
- Evaluating the **precision of calculation methods** and tools
- **Sufficiency of current control environment** in addressing new risks relating to financial and non-financial data, including controls over systems and sources for data dependencies
- **Performance monitoring** and executive reporting

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Benefits and challenges

Benefits

- Enhanced **quality of performance data against set business objectives.**
- Enhanced frequency and quality of data to support **adaptive strategy formulation for navigating threats and opportunities**
- **Increase in reputational equity** due to regulatory compliance
- Confidence in the effectiveness of management's systems & processes
- **Investor comfort** with increased transparency, **business reliance**, and adaptability
- Continuous **learning** & process **improvement**
- **Repeatable concept creation** to leverage improvements and strengthen other ESG reporting processes
- **Improvement in external** agency ratings

Challenges

- **Organization-level alignment** on ESG risks and areas of focus
- **ESG framework & key metrics**
  - Limited/no consensus on what metrics to report or how to calculate
  - Increased expectations from stakeholders
- **Data gathering & reliability**
  - Data sourcing is a combination of financial & non-financial systems, with different levels of data management & maturity
  - Reliance on third-party vendor information
  - Manual intervention required to extract, cleanse, & aggregate data
- **Process & governance**
  - No standardized reporting process – data received in different formats & at different times
  - Metrics are not verified or have poor quality
- **Reporting & analytics**
  - Reporting is mostly manual, and doesn't drive actionable insights
  - Limited self-service analytics tools prevent users from accessing real-time data

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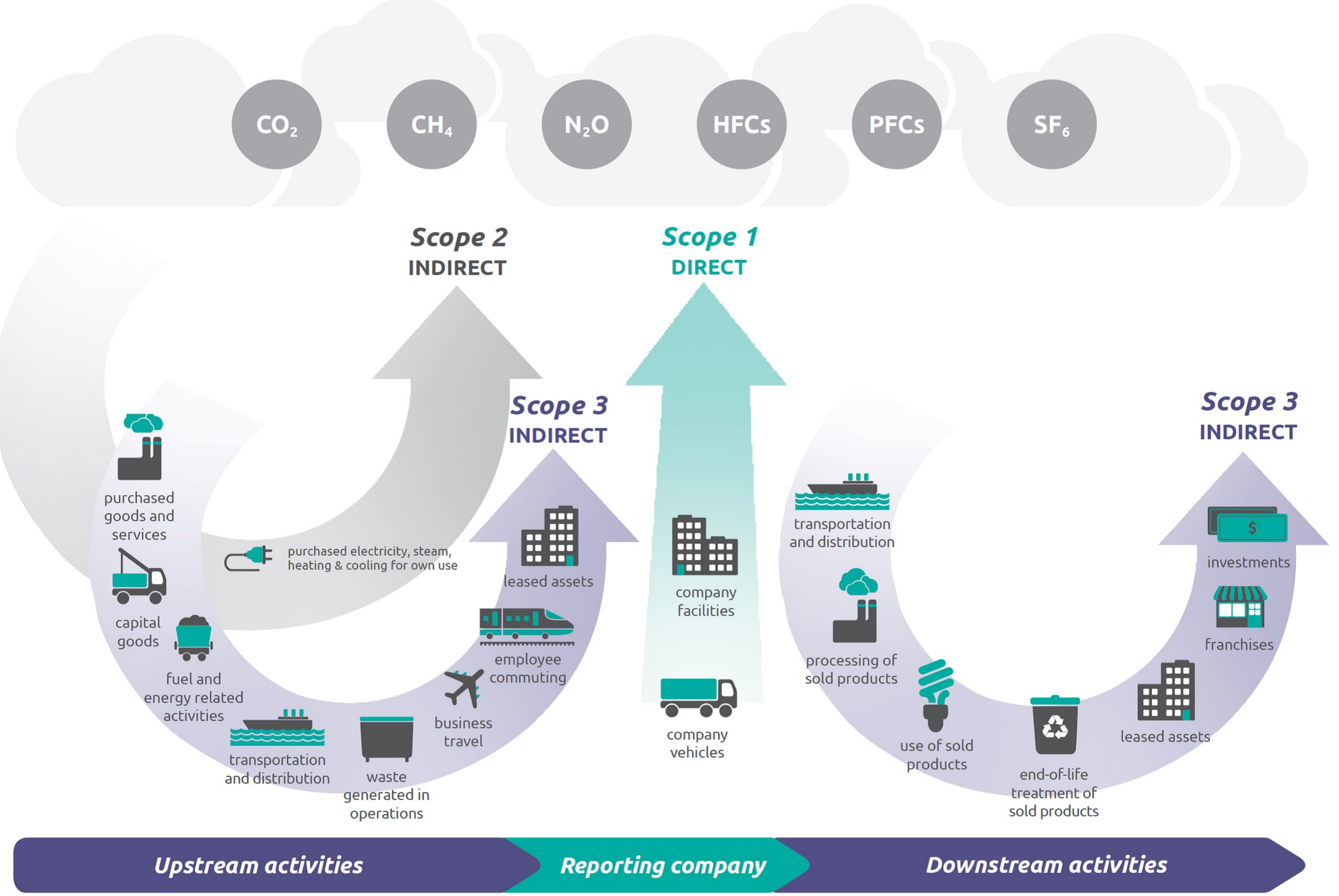
Q&A

Green House Gases (GHG)

Scope 1 - direct GHG emissions that occur from sources that are controlled or owned by an organization (e.g., emissions associated with fuel combustion in boilers, furnaces, vehicles)

Scope 2 - indirect GHG emissions associated with the purchase of electricity, steam, heat, or cooling. Although scope 2 emissions physically occur at the facility where they are generated, they are accounted for in an organization's GHG inventory because they are a result of the organization's energy use.

Scope 3 – GHG emissions that are the result of activities from assets not owned or controlled by the reporting organization, but that the organization indirectly impacts in its value chain. Scope 3 emissions include all sources not within an organization's scope 1 and 2 boundary. The scope 3 emissions for one organization are the scope 1 and 2 emissions of another organization. Scope 3 emissions, also referred to as value chain emissions, often represent most of an organization's total GHG emissions.



Source: Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Standard

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