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Elizabeth Simon (lizsimoncpa@gmail.com) is the Vice President of Compliance & Risk at Progress Residential, working remotely from southwest Florida, USA.

ESG: The monster to be tamed

By Elizabeth Simon, CPA, CFE, CCEP, CIPP/US, LPEC

ESG—environmental, social, and governance—has become the buzzword among businesses today. With Europe leading the way, U.S. companies are quickly catching up. Meanwhile, regulatory authorities are working hard to create standards that apply everywhere. The Securities and Exchange Commission (SEC) in the U.S. has recently increased its involvement in monitoring and regulating this area, leaving many companies unsure about their next steps. Adding to the uncertainty, California has introduced the new California Climate Accountability Package.

If your company is new to the ESG scene and in the early stages of building your program, you're not alone. The main challenge for most companies is figuring out how to collaborate across the different silos of the business involved in ESG, all aiming for the common goal of a robust ESG program.

ESG has changed over time

During the COVID-19 years—when many individuals found themselves compelled to work from home—the social facet of ESG gained heightened importance. Investors began posing more inquiries related to diversity and inclusion. Various social issues arose, spurred by events like the tragic murder of George Floyd. Employee privacy took center stage as companies attempted to implement measures to monitor their workforce, ensuring they were working as claimed. Essential workers—forced to operate in potentially unsafe conditions due to the virus—brought attention to concerns about working conditions, health, and safety.

After the peak of the COVID crisis, investors shifted their focus primarily toward the environmental aspect of ESG. Most ESG frameworks concentrate predominantly on environmental factors. While some elements of the social and governance pillars are included, the emphasis remains on the environmental pillar. In its proposed ESG rules, even the SEC predominantly addresses reporting on carbon emissions rather than diversity, equity, and inclusion (DEI) statistics, executive compensation, or other *social* and *governance* topics.

However, this does not imply a prolonged exclusive focus on the environmental aspect, as social issues have recently caused trouble for companies. Target experienced a significant drop in earnings in 2023, with a 5.4% decline in Q2, including a 10.5% online drop and a 4.8% decrease in foot traffic.[1] The controversy surrounding a Pride Month collection of children's clothing led to a downgrade of their shares.[2] Bud Light retail sales plummeted by up to 42% in certain U.S. metro areas in the four weeks ending on July 22, 2023, after partnering with a transgender influencer during a social media campaign.[3] If a company within your industry sees a value reduction due to ESG-related concerns, investors will be vigilant to ensure your company is not susceptible to a similar situation.

Why is ESG important?

One of the significant challenges associated with ESG programs is the momentum they gather—once aboard the ESG train, stopping becomes difficult. For instance, if your company releases its inaugural ESG report in a given year, shareholders and investors will anticipate subsequent updates to demonstrate ongoing progress in the following years. This sets a precedent, imposing additional annual responsibilities on your company. It becomes imperative for the company to be ready to consistently prioritize and allocate funds to sustain the program once initiated.

Gaining support for an ESG program can be challenging. Without illustrating why the ESG program is crucial for your company, building a robust ESG program becomes an uphill task. Levels of awareness and understanding about the significance of ESG vary among individuals. The recent incidents involving Target and Bud Light highlight situations that have led people to question the importance of ESG, making it a potentially politicized and polarizing topic based on individual perspectives. Striking a balance between adhering to ESG values and managing potential reputational risks is a challenge all companies must confront when articulating the program's significance. Having the C-suite or CEO aligned with the ESG concept—along with investor interest in transitioning toward a more sustainable company—can significantly bolster the program's credibility.

ESG is a monster that must be tamed

Another major ESG challenge lies in the absence of a universally accepted standard to guide practices. In contrast, disciplines like accounting have long relied on Generally Accepted Accounting Principles and, more recently, International Financial Reporting Standards, which extend their reach internationally. Similarly, auditing benefits from Generally Accepted Auditing Standards and the guidance provided by the Institute of Internal Auditors. Compliance has its foundations in the Federal Sentencing Guidelines, coupled with the guidance manuals from the U.S. Department of Justice or U.S. Department of Health and Human Services Office of Inspector General. On the contrary, the multitude of ESG frameworks can overwhelm a compliance practitioner.

The choice of an ESG framework depends on various factors, primarily your company's industry and geographic location. For European operations, the United Nations' frameworks or the Global Reporting Initiative may be suitable. Publicly traded U.S. companies might consider the Sustainability Accounting Standards Board framework, while many opt for the Task Force on Climate-Related Financial Disclosures. The Global Real Estate Sustainability Benchmark might be a preferred choice in the real estate sector. Identifying stakeholders and understanding their priorities is critical in selecting the most appropriate framework or combination.

Beyond the challenge of framework selection, there are numerous topic areas to consider within an ESG program.[4] Even within the three pillars of environmental, social, and governance, these encompass diverse aspects of the business and various topics. Consequently, involving numerous people, departments, and teams becomes essential as you develop your ESG program.

- Legal typically houses the corporate secretary, who conducts tasks such as managing board minutes and overseeing entity management, which falls within the governance pillar of ESG.
- Compliance generally handles policies, procedures, codes of conduct, and the ethics hotline, also aligning with the governance pillar of ESG.
- The operations team is vital for the environmental pillar of ESG, varying significantly based on industry. In manufacturing, the operations team manages solid and liquid waste and control pollutant emissions. In retail, operations manage waste from shipments and product selection. In pharmaceuticals, it's vital to address the disposal of expired medications. In real estate and construction, attention to the turnover

between tenants or buyers is key—including the use of energy-efficient appliances, water heaters, HVAC systems, and sustainable building materials.

- Compensation and benefits impact both governance and social, influencing the social pillar through the company's employee value proposition and engagement scores, and the governance pillar from an executive compensation perspective.
- Health and safety primarily reside in the social pillar, which ensures the safety of employees and communities where the company operates.
- Learning and development fall under the social pillar, involving training employees in various ESG topics and providing leadership development opportunities.
- Facilities manage utilities and waste at corporate offices and company-owned facilities, placing them in the environmental pillar to help reduce energy, water, and waste.
- Fleet management is necessary for tracking and reporting on the environmental pillar, especially if employees drive fleet vehicles.
- DEI teams typically align with the social pillar but may also impact governance in terms of executive diversity. They handle antidiscrimination actions, education, and support for underrepresented groups.
- The board of directors significantly contributes to governance, overseeing ESG and enterprise risk management programs, including diversity of the board.
- Talent acquisition or recruiting teams play a role in the social pillar, contributing to diverse candidate pools and interviews and potentially impacting the governance pillar in executive recruiting.
- Supply chain teams, procurement, and vendor management play roles in both the social and environmental pillars. Procurement can ensure a diverse pool of suppliers and sustainable product options while also facilitating the reporting of Scope 3 emissions from vendors.

Several additional teams to consider are accounting and finance, investor relations, and data analytics. Accounting and financial reporting may seem distant from ESG; however, they play a central role in analyzing the potential costs associated with implementing various ESG initiatives, especially in the initial stages. ESG initiatives often require substantial upfront investment with a potential delay of several years before results become evident. Including accounting in the budgeting purposes becomes essential for effective financial planning. Moreover, with the new SEC rules on ESG disclosures, accounting is closest to any updates and must be involved from that perspective.

The presence of investor relations is highly beneficial as investors increasingly inquire about ESG practices. For publicly traded companies, investor ESG questions may be less frequent, unless there are large investors with a majority interest in the company. However, for venture capital-backed or private equity-owned companies or companies considering an initial public offering, many investors now operate "green funds" where adherence to specific ESG standards is a prerequisite for funding consideration.

Numerous ESG frameworks mandate the submission of data for emissions for Scope 1, Scope 2, and Scope 3. Corporate social responsibility or ESG reports often include goals and metrics that require validation. In this context, it is advisable to involve your data analytics team in calculating the different scopes and your internal audit team in validating claims within external reports.

The basics of carbon emissions

Lately, both investors and regulators have shown a heightened interest in the environmental aspect of ESG. When examining recent ESG regulations, such as the new California laws, it's fundamental to understand the distinctions among Scopes 1, 2, and 3 carbon emissions. With an increasing number of frameworks and regulations necessitating reporting on carbon emissions, it becomes essential to know the specific components of your company. Although the items allocated to each scope may differ, here are some general examples:

- Scope 1 emissions consist of direct emissions stemming from facilities and processes owned by the company. Examples include company-owned vehicles, fuel combustion or industrial processes generated at the company's manufacturing plant, agriculture, forestry, land used by the company, and waste generated at the company's facilities.

- Scope 2 emissions involve indirect emissions primarily linked to energy purchases. Examples include electricity and natural gas consumption at the company's facilities, heat and air conditioning consumption, and steam consumption (if purchased from external sources for manufacturing processes).

- Scope 3 emissions—the most complex and challenging to measure—encompass indirect emissions originating from the company's supply chain as it conducts business. Examples include transportation for the company's waste disposal, emissions created in the manufacturing and transportation of materials purchased from external sources that are used in the company's business processes, business travel (such as airplane emissions), energy and water consumption from leased assets, employee commutes, transportation and distribution for the company's finished products, emissions created from purchased services, emissions from franchisees, and emissions from the usage of sold products.

Scope 3 emissions pose a tracking and calculation challenge, involving numerous indirect emissions in the supply chain. Despite the difficulty, regulators increasingly expect companies to accurately track and calculate these emissions. Involving your supply chain team becomes crucial to gathering necessary information from vendors and suppliers through questionnaires about their Scopes 1 and 2 emissions (which constitute your company's Scope 3 emissions). If you have existing compliance due diligence questionnaires, integrating additional ESG questions into the current process can streamline the information-gathering process.

Compliance professionals are a natural fit

Amid the intricacies of ESG, compliance professionals emerge as the ideal facilitators to unify all stakeholders and shape the program. The compliance team possesses access to all relevant departments and expertise in crafting procedures and guidance. Additionally, their familiarity with both internal and external company committees—often leading a compliance committee and engaging with the board's audit committee—positions them well to contribute significantly. While compliance may not assume ultimate ownership of the ESG program, compliance professionals can play a pivotal role in bringing the program together.

Takeaways

- One of the significant challenges associated with environmental, social, and governance (ESG) programs is the momentum they gather. Once aboard the ESG train, stopping becomes difficult.

- Having the C-suite or CEO aligned with the ESG concept and investor interest in transitioning toward a more sustainable company can significantly bolster the program's credibility.

- Another major challenge with ESG lies in the absence of a universally accepted standard to guide practices.

- Involving numerous people, departments, and teams becomes essential as you develop your ESG program.
- If you have existing compliance due diligence questionnaires, integrating additional ESG questions into the current process can streamline the information-gathering process.

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3 J. Edward Moreno, "Fall in Bud Light Sales Puts Dent in Beer Maker's Earnings," *The New York Times*, August 3, 2023, https://www.nytimes.com/2023/08/03/business/bud-light-sales-decline.html.
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