WHITE PAPER

ESG Reporting – Getting clever with "Smart Compliance"

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Faced with new and rapidly approaching compliance obligations, companies often settle for a short-term firefighting approach, which at first glance implies a low-cost solution. However, this course of action - dealing with new requirements as they arise - has a major drawback. It lacks an overarching vision, neglecting the opportunities for value creation from adopting a more holistic and long-term view. By limiting themselves to the task of meeting immediate compliance obligations, companies will find themselves constantly trying to keep up with fast-moving, ever-changing sustainability regulations. Rather than planning efficiently and strategically, they will be burdened with an increasing reliance on short-term, costly reporting solutions.

Addressing this matter is therefore not merely an avoidance of censure from regulators and investors but should rather be viewed as a strategic exercise that pays commercial dividends, offering a competitive advantage through sustainable value creation. Thus, we believe ESG reporting should be on every CEO's agenda.

This paper outlines an alternative, strategic approach to all the new ESG disclosure regulations and standards emerging around the world. It explains how an institutionalized and automated system ensures compliance with all ongoing requirements, while at the same time minimizing risk and maximizing opportunities. We call this approach "Smart Compliance".

Section 1 – Why companies must pay heed to sustainability reporting

Sustainability reporting is by no means a recent innovation. However, investors and other capital market players have been increasingly calling for reliable and comparable ESG reporting which can aid decision making and is integrated into the financial reporting process. The financial risks and opportunities brought about by ESG topics such as climate impact have fueled this demand. Investors crave the transparency vital for navigating the green transition and helping to build sustainable value creation.

Regulators and standards organizations have responded accordingly, and new mandates for finance-related ESG information are appearing all over the world (Exhibit 1). Most regulations focus on climate-related financial disclosures. The notable exception is the European Union's Corporate Sustainability Reporting Directive (CSRD), which includes not only climate reporting but covers several ESG topics, and furthermore adopts a multi-stakeholder perspective beyond financial reporting.

Standards organizations have also acted. The newly formed International Sustainability Standard's Board (ISSB) is a division of the International Financial Reporting Standards (IFRS) Foundation, whose standards are used in 168 jurisdictions for the purposes of financial disclosure. In June 2023, the ISSB finalized its first two standards for general disclosure (S1) and climate-related financial disclosure (S2). Many jurisdictions, including Australia, United Kingdom, Canada, and Japan, have already indicated that they will also adopt these standards.

Because it has taken a different approach with regards to scope and impacted stakeholders, the European Union (EU) has appointed its own standard-setting body, the European Financial Reporting Advisory Group (EFRAG).

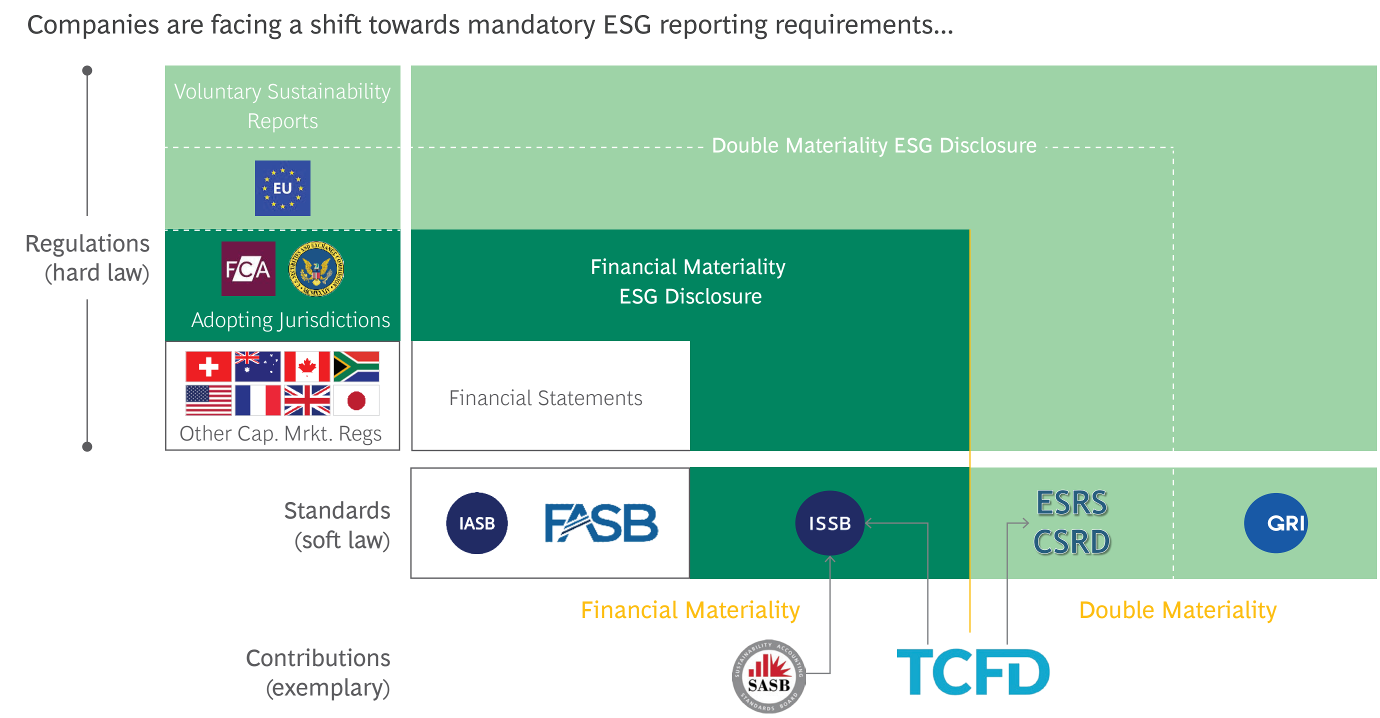
In the United States, the Securities and Exchange Commission (SEC) issued a proposed rule in 2022 on climate-related financial disclosures, set to be finalized in October 2023. The proposed rule did not authorize any specific ESG disclosure standards, but its provisions are generally aligned with the standards of the Task Force on Climate-related Financial Disclosures (TCFD) as are the climate standards in the EU and ISSB.

These new developments have a significant and immediate impact on companies across all sectors and jurisdictions. Although many companies already report ESG information voluntarily, the level of rigor needed to handle the controls and schedules for financial disclosure is much more onerous. Organizations must gauge their current ability to handle these rapidly expanding requirements, identify and prioritize the major structural gaps, and then establish a holistic transformation strategy that will respond smoothly and efficiently to all these issues.

Drawing up an effective and inclusive plan from the outset, integrated to the company's overall strategy, is essential. The latest ESG reporting requirements go beyond compliance to highlight strategic topics which, if not addressed, could cause significant risk to companies. For example, potential constrictions in supply chains which are vulnerable to extreme weather events, and reputational risk due to significant environmental impact. New business opportunities created by new markets in the rapidly advancing green economy may also become evident in the new ESG reporting process. While each company's circumstances are different, this transition should be viewed as an overarching strategic project that can unlock long-term value.

With ESG reporting timelines fast approaching and requirements continuing to evolve, companies must be proactive to create efficient compliance systems that produce lasting business value.

Exhibit 1 - The Development of Mandatory Regulations



Source: BCG.

Section 2 – The Challenge: A strategy for the long term

As ESG regulatory reporting requirements develop, companies must remain simultaneously compliant and competitive. Many companies have voluntarily issued their own sustainability reports, and some of them have done so for a considerable period. Most of these reports have utilized the disclosure standards issued by the Global Reporting Initiative (GRI). More recently, companies have incorporated industry specific disclosures based on the standards from the Sustainability Accounting Standards Board (SASB), and some have aligned with the Sustainable Development Goals (SDGs) or other standards. In addition, almost 20,000 companies voluntarily disclose their climate-related information to the Climate Disclosure Project (CDP) each year.

However, for any company that has issued these voluntary sustainability reports, moving to the new mandatory regime will entail important actions - including:

- **Gap Analysis:** Companies must first assess their current disclosures, governance structures, and management systems against the new requirements. This step should involve more than a simple comparison of the information to be reported. As many of the new requirements are related to governance and management systems, the analysis must look more deeply into the company's management systems, governance structures, and capabilities. The outcome should be a roadmap of what needs to be done, a practical basis for formulating a strategic plan.

- **Schedule:** Voluntary reports are typically issued many months after the deadline for mandatory financial disclosures. The new requirements will require ESG disclosures to be issued in the same timeframe as financial reports, accelerating the previous schedule considerably.

- **Assurance:** All the new mandates require some form of third-party assurance for ESG disclosure. For many companies, assurance of these disclosures is a new process that will take some time and effort to incorporate. Moreover, the standards and process for assurance are also undergoing major changes.

- **Data presence & quality:** New requirements may require companies to increase their data capabilities, as the data needed for disclosure may not currently be collected. In addition, data integrity relies on robust control systems to ensure data quality. Although these systems are more mature for financial reporting, they are still developing for ESG disclosure.

- **Automation of accounting and disclosure:** In the voluntary reporting model, many companies have not integrated their ESG accounting and reporting systems. However, to report climate disclosures, for example, companies will need to source information from all major business units and regions, as well as from the value chain. The automation and systems integration of these processes will be essential elements of success.

- **Future proofing:** The ESG disclosure landscape is moving rapidly, and requirements are still maturing. Moreover, there are regional differences and evolving linkages with voluntary disclosure programs (such as CDP) that must be taken into consideration. To derive long-term business value, organizations must establish systems that anticipate change and can be incorporated into planning processes.

Section 3 – The “Smart Compliance” Approach

“Smart Compliance” is the intelligent approach to meeting the forthcoming ESG disclosure requirements. It goes beyond compliance and leads to sustainable value through an institutionalized approach that both reduces risk and creates opportunities.

As part of “Smart Compliance”, companies need to assess their current ESG strategy towards reporting before embarking on a transformation which creates value.

- **Voluntary to Mandatory:** Companies should evaluate their current reporting status and develop a perspective on how a transition should occur from any current voluntary reporting to the mandatory reporting requirements. It is important to acknowledge some voluntary disclosure commitments may go beyond mandatory reporting requirements. Thus, an optimized target reporting landscape should synergize both current and future requirements.

- **Materiality Assessment:** Regulations have placed materiality at the heart of disclosure, to evaluate the scope of reporting in the most effective way. A materiality assessment, combined with a gap analysis, allows companies to optimize for the scope of topics to report on. In the case of CSRD / ESRS, this not only requires an assessment of financial materiality but also material impact on people or the environment via a double materiality assessment. Given the number of ESG reporting requirements across different departments, companies must carefully gauge materiality to ensure compliance and create sustainable value.

- **Global Reporting Requirements:** The mandatory reporting landscape is continuing to evolve, producing different standards dependent on jurisdictions and entities. Although many climate-related standards are based around TCFD, the depth of reporting requirements will still vary. In addition, CSRD / ESRS has gone beyond climate to incorporate additional environmental, social and governance requirements. Hence, we encourage companies to take a balanced approach which recognizes global operability between standards, while at the same time accounting for local nuances.

Once an initial “Smart Compliance” assessment has been conducted, institutional capabilities must be assessed to enable a transformation:

A. Governance.

B. Business Process Excellence.

C. Data Quality and Controls.

D. Information Systems.

A GOVERNANCE

The new climate standards call for disclosure of board-level competence and roles in relation to climate-related risks. Companies and their directors will therefore have to define and disclose competencies, structures, and individual roles and responsibilities for the purposes of climate-related strategy.

Beyond reporting, the relevant board directors should also oversee the overall sustainability strategy, with a focus on business value creation. To be successful in this endeavor, directors will need to develop their knowledge of sustainability and its business implications. In this way, they will be able to appraise any related opportunities and actions to mitigate risk in an informed way.

In addition to governance, executive management teams must organize themselves to devote the requisite strategic consideration of climate risks and opportunities. Coordination and implementation at the operational level requires multi-discipline management systems to monitor program effectiveness, progress against goals, and efficient reporting.

B BUSINESS PROCESS EXCELLENCE

Regulators require that a company's ESG reporting will be integrated with its current financial reporting process and subject to, at least partial, auditing. Hence, qualitative, and quantitative key performance indicators (KPIs) provided in the ESG report will need to be traceable and verifiable across the organization. However, many companies currently rely on manual processes for ESG data acquisition and disclosure which are not fit for financial reporting. Both finance and ESG reporting processes require inputs from all business operations; thus, integrating ESG reporting with the financial process can optimize synergies.

The aim of the ESG reporting transition should be to build an efficient, in-house, sustainable process. This strategic approach brings five major benefits:

1. Reducing compliance risk
2. Increased investor confidence (lower volatility, increased investment)
3. Lowering the cost of capital by boosting credit ratings
4. Strengthening recruitment, retention, and engagement of the most talented employees
5. Developing a positive brand reputation

C DATA QUALITY AND CONTROLS

The new ESG reporting regime entails the identification, quality control, and assurance of hundreds of KPIs. The underlying data must also be accountable and reliable; a complexity especially apparent in the Scope 3 emission disclosure which requires quantitative accounting upstream and downstream of the value chain. Consequently, building a network of dependable data exchanges that extend to a company's supplier network will be crucial to reporting success. To accomplish this, establishment of robust data controls that lead to quality assured results is a vital element of the transformation.

Key steps in the transformation for ESG data management:

- Assess existing structures and processes for company-wide data management and build a roadmap to automate and integrate ESG information into company enterprise resource planning (ERP) software.
- Establish data control systems for quality, reliability, assurance, and security.
- Providing dashboards, forecasts, and other reports to facilitate decision making and oversight.

As reporting regulations continue to evolve, the task of generating data that is reliable, replicable, and decision-useful is key to compliance and generating business value.

D INFORMATION SYSTEMS

Selecting the appropriate data collection, accounting, storage, and analysis platforms will significantly improve the ESG reporting process. Automating and integrating the ESG disclosure system within the existing ERP environment is essential for efficient and effective management.

ESG accounting and reporting platforms are mushrooming, with a variety of established players and start-ups offering solutions. The information technology department will need to develop a deep understanding of all the stages in the reporting process so that they can select, acquire, and integrate the relevant systems. This entire exercise represents an opportunity to connect and streamline data platforms across the organization.

The ideal solution should be tailored to each individual company's needs based on its current data and systems architecture.

Carefully working through these four areas will enable structures and systems that ensure compliance today and future resilience against a rapidly changing ESG compliance landscape. By managing these changes as a wholistic transformation, companies will identify areas to cut costs, avoid risk, and even discover new business opportunities.

Conclusion – Getting started now

Mandatory ESG reporting is here to stay. As the sustainability landscape develops, companies will need to integrate ESG topics into their financial reporting structures. Similarly, as financial targets & metrics have long been an inherent part of board level discussions, ESG equivalents will become a cornerstone of company strategy. Boards who treat their ESG reporting with the same significance as their financials will not only minimize risk but produce significant long-term gain.

Preparing for this exercise requires an extensive transformation of governance, process, systems, and data, driven by board-level strategic integration. Failure to take appropriate action will leave companies behind the curve and trapped in a cycle of costly, manual disclosure. Instead, taking the "Smart Compliance" approach to ESG reporting readiness allows companies to unlock business value that more passive rivals will fail to capitalize on.

ESG disclosure regulations are driving towards intelligent strategies – are you?

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If you would like to discuss this report, please contact the authors.


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