BICG
BALTIC INSTITUTE OF CORPORATE GOVERNANCE

The Institute of Internal Auditors

ESG Embedding. Are you ready ?

A call for Boards, Risk Managers and Internal Auditors

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Objectives of the session

- Today is **not** a technical session, but a wake up call
  Don't wait and start now

- Provide ideas on where to start
  Each situation is unique

- Simplify / demystify
  There will not be enough consultants to help

- Get to the point of what ESG is – change the mindset, see the opportunity
  A journey, a requirement, a radical scrub to business models

- Allow you to ask questions and share ideas
  To be continued …

What are the main approaches to ESG reporting ?

IFRS Foundation

ISSB – IFRS SS

SEC

EU

What are the texts applicable in Europe?

- CSRD – Corporate Social Responsibility Directive
  - issued on December 14, 2022
- CS3D – Corporate Sustainability Due Diligence Directive
- Sustainability Standards developed by EFRAG – European Financial Reporting Advisory Group
  - Sector-agnostic : draft ESRS (European Sustainability Reporting Standard) issued Nov 2022 and quasi-final (exp June 30, 2023)
  - Sector-specific and SMEs : *under development*

Where do we stand today in our companies?

Poll by Laura

Main trends observed

Where do we stand today in our companies ?

(29) Articles 19a(1) and 29a(1) of Directive 2013/34/EU require reporting not only on information to the extent necessary for an understanding of the undertaking's development, performance and position, but also on information necessary for an understanding of the impact of the undertaking's activities on environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters. Those Articles therefore require undertakings to report both on the impacts of the activities of the undertaking on people and the environment***, and on how sustainability matters affect the undertaking***. That is referred to as the double materiality perspective, in which the risks to the undertaking and the impacts of the undertaking each represent one materiality perspective. The fitness check on corporate reporting shows that those two perspectives are often not well understood or applied. It is therefore necessary to clarify that undertakings should consider each materiality perspective in its own right, and should disclose information that is material from both perspectives as well as information that is material from only one perspective.

10. The Disclosure Requirements in [draft] ESRS 2, in the [draft] topical ESRS and in [draft] sector-specific ESRS cover the following reporting areas:

(a) **Governance** (GOV): the governance processes, controls and procedures used to monitor and manage impacts, risks and opportunities (see [draft] ESRS 2, chapter 2 *Governance*);

(b) **Strategy** (SBM): how the undertaking's strategy and business model(s) interact with its material impacts, risks and opportunities, including the strategy for addressing them (see [draft] ESRS 2, chapter 3 *Strategy*);

(c) **Impact, risk and opportunity management** (IRO): the process(es) by which impacts, risks and opportunities are identified, assessed and managed through policies and actions (see [draft] ESRS 2, chapter 4 *Impact, risk and opportunity management*); and

(d) **Metrics and targets** (MT): how the undertaking measures its performance, including progress towards the targets it has set (see [draft] ESRS 2, chapter 5 *Metrics and targets*).

3.4 Impact materiality

46. A sustainability matter is material from an impact perspective when it pertains to the undertaking's material actual or potential, positive or negative impacts on people or the environment over the short-, medium- and long-term time horizons. Impacts include those caused or contributed to by the undertaking and those which are directly linked to the undertaking's own operations, products, or services through its business relationships. Business relationships include the undertaking's upstream and downstream value chain and are not limited to direct contractual relationships.

3.5 Financial materiality

52. A sustainability matter is material from a financial perspective if it triggers or may trigger material financial effects on the undertaking. This is the case when it generates or may generate risks or opportunities that have a material influence (or are likely to have a material influence) on the undertaking's cash flows, development, performance, position, cost of capital or access to finance in the short-, medium- and long-term time horizons. Risks and opportunities may derive from past events or future events and may have effects in relation to:

(a) assets and liabilities already recognised in financial reporting or that may be recognised as a result of future events; or

(b) factors of value creation that do not meet the financial accounting definition of assets and liabilities and/or the related recognition criteria but contribute to the generation of cash flows and more generally to the development of the undertaking. The latter factors are generally referred to as "capitals" in frameworks promoting a multi-capital approach; the capitals may in some cases (but not in all cases) meet the criteria for recognition and reporting in financial statements.

3.7 Level of disaggregation

58. When needed for a proper understanding of its material impacts, risks and opportunities, the undertaking shall disaggregate the reported information:

    (a) by country, when there are significant variations of material impacts, risks and opportunities across countries and when presenting the information at a higher level of aggregation would obscure material information about impacts, risks or opportunities; or

    (b) by significant site or by significant asset, when material impacts, risks and opportunities are linked to a specific location or asset.

4. Sustainability due diligence

63. Sustainability due diligence is the process by which undertakings identify, prevent, mitigate and account for how they address the actual and potential negative impacts on the environment and people connected with their business. These include negative impacts caused or contributed by the undertaking and negative impacts which are directly linked to the undertaking's own operations, its products or services through its business relationships. Sustainability due diligence is an on-going practice that responds to changes in the undertaking's strategy, business model, activities, business relationships, operating, sourcing and selling contexts. This process is described in the international instruments of the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises.

5. Value chain

5.1 Reporting undertaking and value chain

67. The information about the reporting undertaking provided in the sustainability statements shall be extended to include information on the material impacts, risks and opportunities connected to the undertaking through its direct and indirect business relationships in the upstream and/or downstream value chain ("value chain information"). In extending the information about the reporting undertaking, the undertaking shall include material impacts, risks and opportunities connected with its upstream and downstream value chain(s):

    (a) following the outcome of its sustainability due diligence process(es) and of its materiality assessment; and

    (b) in accordance with specific requirements of [draft] topical ESRS, when they exist.

Business relationships	The relationships the undertaking has with business partners, entities in its value chain, and any other non-State or State entity directly linked to its business operations, products or services. Business relationships are not limited to direct contractual relationships. They include indirect business relationships in the undertaking's value chain beyond the first tier, and shareholding positions in joint ventures or investments.

Assessment of impact materiality

AR 4. In assessing impact materiality and determining the material matters to be reported, the undertaking shall consider the following four steps:

(a) understanding of the context in relation to its impacts including its activities, business relationships, sustainability context and stakeholders;

(b) identification of actual and potential impacts (both negative and positive), through engaging with relevant stakeholders and experts. In this step, the undertaking may rely on scientific and analytical research on impacts on sustainability matters;

(c) assessment of the materiality of its actual and potential impacts; and

(d) determination of the material matters. In this step, the undertaking shall adopt thresholds to determine which of the impacts will be covered in its sustainability statements.

What are the major implementation deadlines?

- June 30, 2023 : sector agnostic ESRS
- During 2023 : SMEs - 2023/2024 : sector specific ESRS
- FY starting on or after Jan 1, 2024 (1st publication 2025)
  - PIEs with more than 500 employees
- FY starting on or after Jan 1, 2025 (1st publication 2026)
  - Large undertakings (or parent undertakings of large group) other than previous ones
- FY starting on or after Jan 1, 2026 (1st publication 2027)
  - Listed SMEs (except micro-undertakings)
  - Small and non complex institutions, captive insurance undertakings
- FY starting on or after Jan 1, 2028 (1st publication 2029)
  - Third country undertaking with net turnover of more than 150m€ in the EU

Accounting directive 2013/34/UE

Undertaking or group do not exceed the limits of at least 2 of the 3 following criteria :

In € Undertaking or group At balance sheet date	Micro Art 3(1)	Small Art 3(2)	Medium-size Art 3(3)
Balance sheet total	350k	4m	20m
Net turnover	700k	8m	50m
Average number of employees	10	50	250

What are the main steps for implementation in our companies?

1. This is a project – Start early, manage as a project and refine on an on-going basis (learn on the go). Eg. SOX implementation projects back in 2006
2. Identify the person in charge as well as associated information owners (internal experts), and develop reporting and technical expertise (ESRS, frameworks). Leverage collective reading and willingness to engage
3. Define a broadly phased approach (retroplanning), break down the complexity (groups), allow for a dry-run (possibly gradual convergence from current reporting), and leverage information owners (allocate)
4. Build a first model of your value chains (to be refined later), including identification of business relationships, and a high-level understanding of where your impacts are (prioritization)
5. Identify network of external experts needed (depending on impacts)
6. Develop a methodology for due diligence, impact assessments, materiality assessments, and implement (involve risk management staff)
7. Assess gaps vs targets (or develop targets); put all internal and external ESG communication on hold for assessment (potential liability)

What are the main steps for implementation in our companies?

8. Identify applicable DRs and datapoints (narratives or metrics / mandatory, voluntary, company-specific) and implement (modelization, systems, processes, internal control)
9. Leverage senior executives and governance regarding strategic matters and impact on business model
10. Develop policies (re. 7.) and action plans / timelines, and sub-projects for implementation
11. Use consultants / external experts on an ad-hoc basis (expertise, touchstone, review as you go, dry-runs)
12. Test pilot sub-projects before deployment (and take lessons on board)
13. Identify transversal topics : data governance, reporting system, internal control documentation (and system)
14. Leverage internal audit as a resource center : trainers, reviewers, contributors in assistance to operations, impact assessment, coordination with experts, internal assurance
15. Identify and use a good writer to develop the narratives (no longer marketing) – Financial communication background will help

Where do we stand today at our companies?

Testimony by some participants

Alignement with other major frameworks

- TCFD – Task force on climate-related disclosures
- GHG Protocol Corporate Standard (version 2004) (≠ reporting boundaries)
- TFND – Task force for nature related financial disclosures
- GRI – Global Reporting Initiative
- UN Guiding Principles on Business and Human Rights
- OECD Guidelines for Multinational Entreprises
  - Part I – II General policies, A.10 to A.12 and related commentaries
  - Part II – IV. Human Rights, Principles 1 to 6 and commentary (45.)
  - OECD Due Diligence Guidance for responsible business conduct
- UN Global Compact
- ISO 26000 on social responsibility
- UN Principles for responsible investment
- ICGN Global Governance Principles

Recommended readings (non-exhaustive list)

- EFRAG : How to improve climate-related reporting, A summary of good practices from Europe and beyond

  (https://www.efrag.org/Lab1)

  - Supplement 2 : Scenario analysis pratices – Assessing resilience, risks and opportunities

    (https://www.efrag.org/Assets/Download?assetUrl=/sites/webpublishing/SiteAssets/European%20Lab%20PTF-CRR%20%28Supplement%202%29.pdf)

- Flying blind - The glaring absence of climate risks in financial reporting

  (https://www.unpri.org/accounting-for-climate-change/flying-blind-the-glaring-absence-of-climate-risks-in-financial-reporting/8555.article)

- Tackling transferred emissions

  https://business.edf.org/files/Climate-Principles-Asset-Transfer.pdf

- CS3D
- Black Box Thinking, Matthew Syed

Role of governance (beyond strategy)

(b) in ***paragraph 6***, points (a) to (e) are replaced by the following:

'(a) inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and***, where applicable,*** of the outcome of the assurance of sustainability reporting and explain how the statutory audit and the assurance of sustainability reporting contributed to the integrity of financial reporting and sustainability reporting ***respectively,*** and what the role of the audit committee was in that process;

(b) monitor the financial and***, where applicable,*** sustainability reporting process, including the electronic reporting process as referred to in Article ***29d of Directive 2013/34/EU*** and the process carried out by the undertaking to identify the information reported in accordance with the sustainability reporting standards adopted pursuant to Article ***29b*** of that Directive, and submit recommendations or proposals to ensure their integrity;

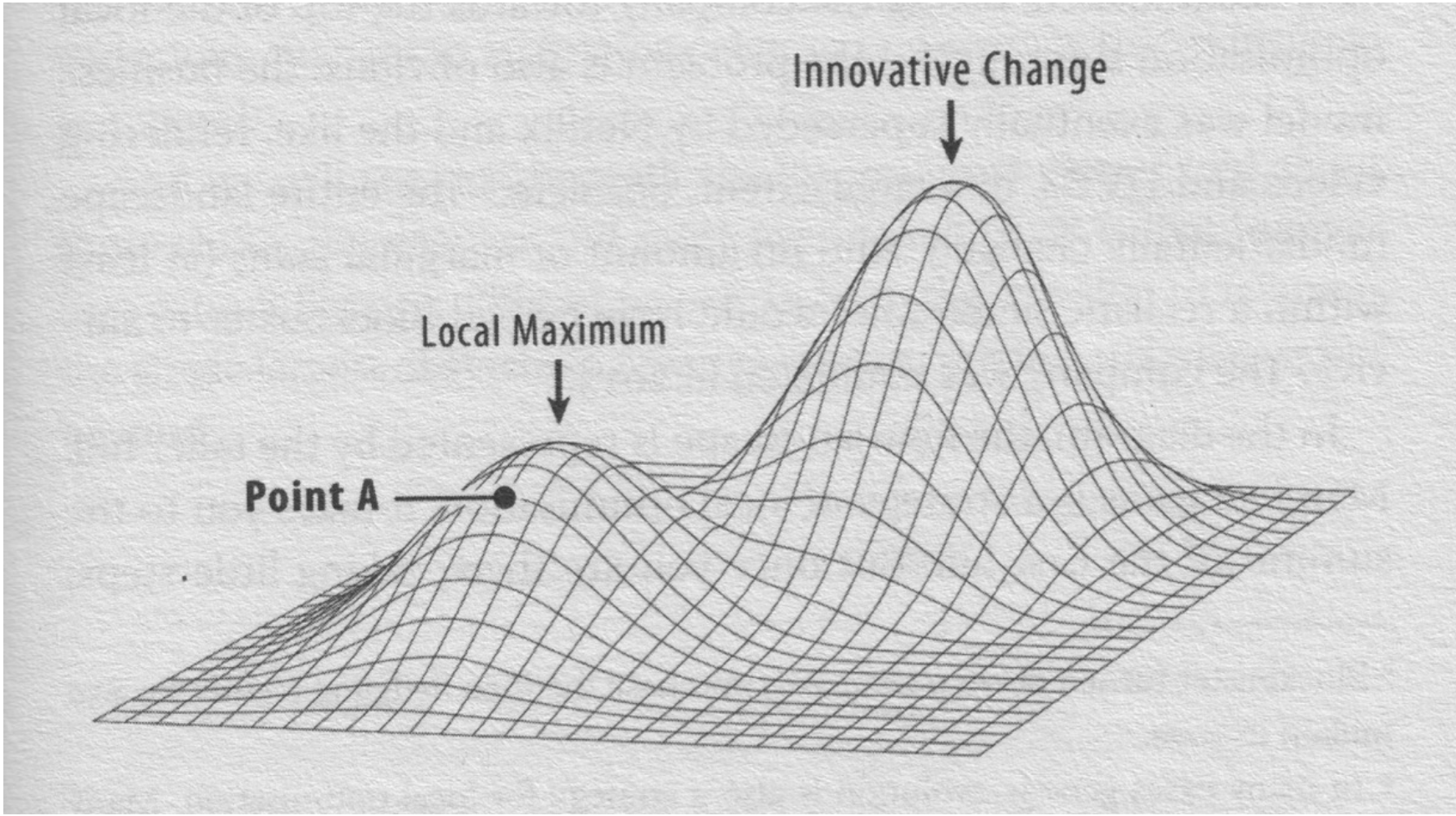
(c) monitor the effectiveness of the undertaking's internal quality control and risk management systems and, where applicable, its internal audit, regarding the financial reporting and***, where applicable,*** sustainability reporting of the undertaking, including its electronic reporting process as referred to in Article ***29d of Directive 2013/34/EU***, without breaching its independence;

(d) monitor the statutory audit of the annual and consolidated financial statements and***, where applicable,*** the assurance of the annual and consolidated sustainability reporting, in particular its performance, taking into account any findings and conclusions by the competent authority pursuant to Article 26(6) of Regulation (EU) No 537/2014;

(e) review and monitor the independence of the statutory auditors or the audit firms in accordance with Articles 22, 22a, 22b, 24a, 24b, 25b***, 25c and 25d*** of this Directive and ***with*** Article 6 of Regulation (EU) No 537/2014, and in particular the appropriateness of the provision of non-audit services to the audited entity in accordance with Article 5 of that Regulation;';

What about the role of the board and other committees ?

Marginal gains vs Innovative change – what does it take to embrace sustainability for real ?



Source : Black Box Thinking, Matthew Syed, Editor John Murray 2016

Some questions asked by participants

- Is there a particular role to be played by **Risk Managers** in the ESG field where there are still so many unknowns and uncertainties?
- What would be the focus point for an **Internal Auditor** to ensure that the sustainability reporting in the company is done correctly?
- How in depth will the **External Auditors** go when reviewing the sustainability report?
- Please provide practical examples on **Board involvement** in ESG matters.
- Please share information on where to further **develop knowledge** in implementing sustainable strategy and complying with the new sustainability regulation

ESG Embedding. Are we ready? Not sure …

- Remember the steps mentioned above
- Build on the foundation your company has established (NFRD or voluntary reporting)
- Take on board the ESRS published by EFRAG quickly
- Start the discussion with your peers in your industry sector (sector-specific will come soon)
- Leverage resources internally and externally in a smart way
- Talk to the third-party experts who will be the Assurance Providers of tomorrow
- **Don’t wait to start the process – Embrace the opportunity**