The Path Forward

The Road to ESG and Sustainability Reporting

ESG Considerations for Private Companies

ESG: It's everywhere you look

- Environmental, Social and Governance—or ESG—is the term that seems to be everywhere these days, which is largely the result of the considerable number of changes on the horizon that could impact every type of business.
- Until recently, ESG (also known as "sustainability") reporting was more of a niche. Most companies reporting this information did so voluntarily to bolster their reputations. However, this dynamic has been changing rapidly since the investment community tapped into the value of ESG data. For example, the world's largest institutional investor—BlackRock—has threatened to vote its shares against any portfolio company that doesn't fall in line with carbon reporting.


Forbes

FINANCE • BLACKROCK

BlackRock is laying out how it expects companies to target net-zero

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February 17, 2021 5:51 AM EST

Why is this important to me?

- Not only is it important that companies use their resources to make the world a better place, but ESG also is good business. For example, conserving energy, using renewable energy, and recycling can reduce costs and help the environment.
- Job hunters, consumers, and investors value ESG and may bypass a company that doesn't.
- Eight of the top 10 global risks identified by the World Economic Forum are ESG related.
- It can improve the bottom line as it can lead to new markets and business opportunities.
- Creating an ESG program can help a company futureproof its operations by anticipating changes.

What is ESG?

- Environmental, Social, and Governance (ESG) focuses on a company's efforts in those three areas. ESG is used by investors when considering where to invest. ESG also should be a factor in developing a company's policies and products.
- ESG requires a holistic evaluation of the business to determine how it serves its stakeholders inside and outside of the company and the environment where it has influence. The relative focus on environment, social, and governance will vary by company.

Environmental

- Focus on environmental should include the company's use of natural resources, conservation efforts, and recycling and sustainability. Companies also may evaluate their carbon footprint and energy use. If the business involves the use of chemicals, the company might determine if there is a more environmentally friendly option.
- Environmental takes into account a company's utilization of natural resources and the effect of their operations on the environment, both in their direct operations and across their supply chains.
- Companies that neglect to consider the effects of their policies and practices on the environment may be exposed to higher levels of financial risk.

Social

- Social issues require evaluation of the company's diversity and inclusion efforts from the boardroom to entry-level employees. Wellness programs and work environment must be evaluated to assure that employees are treated fairly and can work safely and without harassment. Companies also should consider their opportunities for social impact to make the world a better, safer, and more just place where all people can thrive.
- A number of social factors can affect a company's financial performance, ranging from short- to long-term challenges.
- Social factors to consider in sustainable investing include a company's strengths and weaknesses in dealing with social trends, labor, and politics. A focus on these topics can increase profits and corporate responsibility.

Governance

- Governance focuses on a company's leadership and how it guides the company to have a positive impact. Governance also will include evaluating the board, executive, and management composition for diversity and inclusion. It also focuses on equity in compensation, transparency with investors and other stakeholders, and integrity.
- Understanding governance in ESG is critical, as risks and opportunities will increase as social, political, and cultural attitudes continue to evolve.

What is ESG reporting?

- ESG reporting refers to the disclosure of data covering the company's operations in three areas: environmental, social and corporate governance. It provides a snapshot of the business's impact in these three areas for investors.
- The analysis of performance across these ESG factors summarizes quantitative and qualitative disclosures and helps screen investments. ESG reporting helps investors avoid companies that might pose a greater financial risk due to their environmental performance or other social or governmental practices.
- Many companies chose to integrate their ESG reporting in their annual reporting to demonstrate how sustainability is embedded in their business; however, there is a gap between demand for ESG information and supply. Investors especially, want more financially material and higher quality information to inform their decisions. This gap is driven by several factors including, non-mandatory reporting regimes, a range of ESG reporting standards and frameworks and costs to collect and report data.

Why is ESG Reporting Important

- While it's still voluntarily for most countries, there are increasing global regulations regarding corporate ESG data reporting.
- It's a top-of-mind consideration for investors and asset managers
- Strong performance across all three pillars of ESG is indicative of business resilience and success
- ESG transparency will be a key focus for companies in 2021 and beyond.
- Companies that do not provide reporting show a lack of transparency and concerned investors may overlook them as potential investments.

What are the reporting standards and frameworks?

- There are many various frameworks, standards and guides out there that companies can and do follow depending on their specific needs and requirements. Many companies however have been generally using the following sources.

SASB | TCFD | CDSB Climate Disclosure Standards Board | CDP DISCLOSURE INSIGHT ACTION | GRI Empowering Sustainable Decisions

- Update – Groups have continued to announce consolidation to align reporting

SASB

Sustainability Accounting Standards Board

- The goal of the Sustainability Accounting Standards Board (SASB) is to create a set of industry-based standards to measure the financial impacts of sustainability, e.g., those that are material. SASB does not issue a rating, and companies can choose or omit metrics within the framework, as long as they provide a disclosure explanation in the changes.
- Think of this as a starter framework and one that is not overly focused on climate change unless that topic is highly significant to your industry. Investors tend to know this framework well, and it is not so far reaching as to be overly daunting to companies internally. To date, there are about 500 companies that report aligned with the framework.

TCFD

Task Force on Climate Related Financial Disclosure

- The Task Force on Climate-related Financial Disclosure (TCFD) was created to support the goals of the Paris Climate Agreement in 2015. It is a voluntary disclosure platform and does not provide a rating or a grade. It focuses only on climate through four pillars: governance, strategy (i.e., scenario analysis), risk management, and metrics/targets.
- TCFD gained recognition and traction as an important framework in 2020 when Larry Fink and BlackRock asked all portfolio companies to disclose climate-related risks in line with TCFD. A recent Clermont Partners article details the newest 2021 mandates from Larry Fink's Annual Letter.

CDSB

Climate Disclosure Standards Board

- CDSB offers companies a framework for reporting environmental information with the same rigor as financial reporting. The framework encourages standardized reporting to assist investors and stakeholders properly consider the impacts of natural capital on corporate performance along side financial performance.
- The CDSB sets a series of principles by which reporting companies should follow when disclosing environmental information in mainstream reports.

CPD

Carbon Disclosure Project

- CDP (formerly, Carbon Disclosure Project) is one of the oldest and most well-regarded sustainability reporting frameworks. It includes three questionnaires -Climate Change, Forestry, and Water Security, and companies can choose to complete all or just one. Remember that each company gets a grade, and few companies receive an A. Expect a starter grade to be a low C and additional disclosures will likely move your company to the B range. If a customer, investor, or supplier request your company to complete a survey and no response is submitted, then the company will automatically receive an F.
- Participation in CDP is becoming the norm, especially for mid-to large-cap companies. If your company chooses to fill out the climate change questionnaire, it is now two-thirds of the way to TCFD alignment. Expect this to take up to 50 hours, and the first reporting year may have a lot of blanks.

GRI
Global Reporting Institute

- The Global Reporting Initiative (GRI) is an international independent standards organization that many companies report partially aligned with. This is for more global companies and for companies focused on reporting to multiple stakeholders, not just investors. It is the most comprehensive framework covering Environmental and Social factors.
- The framework tracks SASB, CDP, and the UN Sustainable Development Goals. GRI standards are topic specific and are used to report material economic, environmental, or social topics to a range of stakeholders.

Why should I care?
This only relates to public companies and funds?

- In March, Acting SEC Chair Allison Herren Lee spoke about the SEC's enhanced focus on ESG, which she said was driven by a "shift in investor focus." She noted that "ESG risks and metrics now underpin many traditional investment analyses on investments of all types–a dynamic sometimes referred to as 'ESG integration.'"
- According to Lee, the "perceived barrier between social value and market value is breaking down. This change is driven by investors, lenders, asset managers, and ultimately consumers, making it an essential consideration for every business, whether or not under SEC regulation.
- Further, the SEC now has set the expectation that reporting companies accurately disclose ESG information and programs. Investors and other stakeholders naturally will come to expect similar information from private businesses.

Okay, so what do I do now?

- Invest Time
  - Invest some time to understand important ESG topics to your company and its stakeholders
  - Review the frameworks and standards to determine the expectations
  - Education and Commitment (top to bottom)
- Self Reflection
  - Ask difficult questions (Climate, Resources, Diversity, Human)
  - Do we care? What are we doing? Successes, failures, improvements
  - What's our industry's involvement
  - Assess current level of disclosure and gaps in reporting/standards
- Asset Allocation and Budget
  - Can determine where to go next
  - Are resources being used to undermine or support the strategy

Final thoughts

- ESG disclosure is only going to become more important as investors increasingly understand the importance of ESG practices in mitigating risk and opening up opportunity. While it can feel like a monumental challenge to take on ESG communications for your Company, the good news is that you can gain a lot of ground by leveraging work that has already been done.

Accounting Update

New Pronouncements, Leases, Proposed Standards

New Pronouncements – Effective in 2021

ASU 2021-02 *Franchisors – Revenue from Contracts with Customers: Practical Expedient*

ASU 2021-03 *Intangibles – Goodwill and Other: Accounting Alternative for Evaluating Triggering Events*

ASU 2018-17 *Consolidation: Targeted Improvements to Related Party Guidance for VIEs*

ASU 2018-15 *Intangibles – Goodwill and Other – Internal-Use Software: Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract*

ASU 2017-12 *Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities*

ASU 2021-02, *Franchisors – Revenue from Contracts with Customers: Practical Expedient*

- Issued to reduce the complexity of applying Topic 606 to initial franchise fees
- ASU allows for **specific** pre-opening services to be distinct from license
  - Site selection
  - Obtain/prepare facilities
  - Training and materials
  - Bookkeeping, IT, and advisory services
  - Inspection, testing, and QC
- Applies only to identifying performance obligations (not allocating transaction price)
- If ASC 606 was adopted – apply retrospectively to date of adoption
- If ASC 606 was not adopted – follow transition guidance in Topic 606

ASU 2021-03, *Intangibles – Goodwill and Other: Accounting Alternative for Evaluating Triggering Events*

- Issued to reduce cost and complexity in triggering event analysis throughout period
- Became more apparent during COVID pandemic
  - Initial business downturn (Mar 20)
  - Subsequent upturn (by Dec 20)
- Evaluate triggering events at end of reporting period only
- Only applies to goodwill (not other assets or other intangibles)
- Available on an ongoing basis, not just reporting periods affected by COVID pandemic
- Prospective application and one-time exception to adopt without assessing preferability

ASU 2018-17, *Consolidation: Targeted Improvements to Related Party Guidance for VIEs*

- Issued to improve VIE guidance
- May elect **not** to apply VIE guidance to legal entities under common control (including leasing arrangements)
- Must apply to **all** current and future legal entities under common control
- Expands ASU 2014-07 that is for common control leasing arrangements only
- Certain criteria must be met
- Retrospective application
- Private companies only

ASU 2018-15, *Intangibles – Goodwill and Other – Internal-Use Software: Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract*

- If a cloud computing arrangement includes a license for internal-use software, then capitalize
- If it does not include a software license, then expense (because it is a service contract)
- Issued to clarify accounting for implementation activities when the arrangement is a service contract
- Requires companies to potentially capitalize significant implementation costs that were previously expensed, and amortize over the hosting arrangement
- Retrospective or prospective application to all implementation costs incurred after the date of adoption

ASU 2017-12, *Derivatives and Hedging – Targeted Improvements to Accounting for Hedging Activities*

- Applies to any entity that elects to apply hedge accounting
- Includes liberalized requirements for hedge accounting for transactions entered into by private entities
  - Receive variable, pay fixed interest rate swaps
  - Commodity derivatives
- Eliminates concept of hedge ineffectiveness
- Allows private entities to document hedge effectiveness later than prior to hedge inception (more aligned with issuance of the financial statements)
  - Still need to identify the hedging instrument, the hedged item or transaction, and the nature of the risk being hedged
- Simplifies effectiveness considerations, if certain conditions are met
- Disclosure modification
- Detailed transition requirements

New Pronouncements – Issued in 2021

ASU 2021-02	*Franchisors – Revenue from Contracts with Customers Practical Expedient*
ASU 2021-03	*Intangibles – Goodwill and Other: Accounting for Evaluating Triggering Events*
ASU 2021-05	*Leases: Lessors – Certain Leases with Variable Lease Payments*
ASU 2021-07	*Compensation – Stock Compensation: Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards*
ASU 2021-08	*Business Combinations: Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*
ASU 2021-09	*Leases (Topic 842): Discount Rate for Lessees that are not Public Business Entities*

ASU 2021-05, *Leases: Lessors – Certain Leases with Variable Lease Payments*

- Issued because lessors were required to recognize a loss at lease commencement for certain sales-type leases with variable payments, even if was expected to be profitable overall
- Most common in energy and consumable goods industries
- New guidance for lessors only
- Classify leases with variable payments as operating if:
  - Lease would be a sales-type lease or direct financing lease, and
  - Lessor would otherwise have a day-one loss
- Day-one loss or profit is not recognized under operating lease accounting
- Effective for fiscal years beginning after December 15, 2021

ASU 2021-07, *Compensation – Stock Compensation: Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards*

- Issued determining the FV of private company share-option awards at grant date or modification is costly and complex
- Provides a practical expedient for determining FV of equity shares
  - One of the inputs into an option pricing model
- Reasonable application of a reasonable valuation method may be used
  - Section 409A valuation
- Not limited to a valuation by independent appraisal
- Only available for equity-classified awards
- Elected on a measurement-date-by-measurement-date basis
- Effective prospectively for awards granted or modified during fiscal years beginning after December 15, 2021

ASU, 2021-08, *Business Combinations: Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*

- Issued to improve accounting for acquired revenue contracts
- Current guidance generally requires fair value revaluation for all assets and liabilities
- New guidance requires recognition and measurement in accordance with ASC 606, as if acquirer originated the contract
- Should result in acquirer recognizing and measuring contract assets and liabilities consistent with how they were accounted for by the acquiree
- Effective for private entities for fiscal years beginning after December 15, 2023
- Applied prospectively
- If early adopted, retrospective application

ASU 2021-09, *Leases (Topic 842): Discount Rate for Lessees that are not Public Business Entities*

- Issued on November 11
- Improve discount rate guidance for lessees that are not public business entities
- Currently, practical expedient election available to nonpublic business entities
  - Use the risk-free rate as discount rate for all leases
- New ASU allows them to elect to make the risk-free rate election by *class of underlying asset*
  - Not entity-wide level
- Effective when adopting ASC 842
- If already adopted ASC 842, then effective for fiscal years beginning after December 15, 2021

Leases

- ASC 842 becomes effective for private entities in 2022
- Carefully consider election of practical expedients
  - Reporting requirements
  - Types of leases
  - Other accounting policy elections
- Recent poll of executives
  - 19.8% of companies feel unprepared to comply
- All leases will be on the balance sheet through right of use (ROU) assets and lease liabilities
  - Operating leases will be on the balance sheet
  - Capital leases become finance leases
  - Concept of deferred rent is eliminated
- Calculating ROU assets and liabilities can be complex

Leases

- No scope exception for smaller leases built into the codification (like International Standards)
  - e.g. leases of low-value assets such as personal computers or copiers
  - Materiality can and should always be considered
  - Entities can establish reasonable capitalization policies
- Applies to all identifiable assets, *except*:
  - Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources
  - Biological assets, including timber
  - Assets under construction
  - Intangible assets
  - Inventory

Major Differences Between Legacy GAAP and ASC 842

FOR LESSEES	FOR LESSORS
Lease classification determination at the commencement date not the inception date	Fewer leases will be classified as direct financing
Lessees will recognize both operating and finance leases on the balance sheet as an asset and liability	Fewer upfront costs (initial direct costs) will qualify for deferral
No specific bright line tests and one additional criteria on specialized nature of asset	Unusual outcomes may result when sales-type leases contain primarily variable consideration
New financial statement disclosures are required	New financial statement disclosures are required

Transition Practical Expedients

- Package of three that must be elected together:
  - Not reassess whether a contract is or contains a lease
  - Not reassess the lease classification and simply maintain the original classification
  - Not reassess initial direct costs
- Other a la carte expedients:
  - Use hindsight in determining lease term and assessing the impairment of ROU assets
  - Elect not to assess whether existing or expired land easements that were not previously accounted for as leases are or contain a lease

Ongoing Practical Expedients

- Short Term Leases
  - As an accounting policy, entities may elect not to record "short-term" leases on the balance sheet.
- Combining lease and non-lease components
  - Lessees may choose not to separate non-lease components from their related lease components. Rather, the lessee would account for a lease component along with all its related non-lease components as a single lease component.
- Risk Free Discount Rate
  - A lessee that is not a public business entity can elect by class of underlying asset to use a risk-free discount rate, determined using a period comparable to the lease term, as the discount rate for the lease.

Steps to Take Now for Lease Readiness

- Collaborate with other departments
  - Accounting and finance with operations
  - Ensure list of leases to consider for implementation is accurate
  - Communicate new leases or modifications to accounting in real time
- Remain alert to contracts that are or contain leases
  - Analyze each contract to determine if it contains a lease
  - Contracts that include outsourcing services, data centers, hosting, or other IT services commonly contain embedded leases
  - May not have been a lease in the past

Steps to Take Now for Lease Readiness

- Don’t reinvent the wheel
  - Leverage experience and knowledge of professionals
  - Consider investing in lease management software
- Discuss impacts with management
  - Financial ratios may be affected
  - Review debt agreements and discuss with bankers
- Document significant aspects of implementation
  - Update accounting policies
    - Practical expedients elected
    - Judgments
    - Assumptions
  - Materiality and internal controls
  - Policies should be forward-looking
  - Align implementation decisions for existing leases with treatment for new leases

Proposed Standards – Exposed in 2021

- Derivatives and Hedging (Topic 815): Fair Value Hedging – Portfolio Layer Method
- Invitation to Comment – Agenda Consultation
- Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions
- Interim Reporting (Topic 270): Disclosure Framework – Changes to Interim Disclosure Requirements

Thank You!