5 Critical Steps For Ensuring ESG Transparency

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The U.S. Securities and Exchange Commission expects to develop environmental, social and corporate governance climate change disclosure policies by year-end to catch up to E.U. authorities.

ESG disclosures are a subset of broader employee, investor and public-at-large demands for more transparency into the nonfinancial information, or NFM, companies use to make critical decisions.

NFMs are measurements or key performance indicators companies use to evaluate operational performance. NFMs vary from company to company and industry to industry, and may combine internal and external information.

For example, consumer products companies monitor their products' market share; social media sites measure the number of active users; digital marketers track advertisement click-through rate; and, from an ESG perspective, a company reports its scopes 1, 2 and 3 greenhouse gas emissions.

Unlike financial reporting, which is the finance and accounting province, NFM disclosure thrust lawyers into center stage.

Financial metrics and reporting draw from sophisticated, automated and independently audited accounting systems known as internal controls over financial reporting, or ICFR. NFM derives from informal and noncontrolled sources, including spreadsheets, emails and loosely controlled systems, and does not have the benefit of independent audit to ensure accuracy.

To mitigate legal risk, in-house and external counsel serve a critical oversight role to ensure the accuracy of NFM and the integrity of data and processes supporting NFM disclosures. Stated differently, ICNFR, or internal control over nonfinancial reporting, is for lawyers like ICFR is for accountants.

Here, we present the five critical steps counsel should take to ensure their companies and clients meet NFM reporting expectations. Time is of the essence because chances are these steps will identify gaps and controls deficiencies the organization must remediate now to avoid inaccurate disclosures later.

1 Leverage COSO and ICFR to avoid reinventing the wheel.

The Committee of Sponsoring Organizations of the Treadway Commission, or COSO,[1] refers to the de facto standard to identify and mitigate operational, compliance and reporting risks.

Your company or client likely already has a COSO-based ICFR framework if it publicly reports financial information. And its compliance program likely also draws upon COSO.

Lawyers must become familiar with COSO to understand and ensure the accuracy of ICNFR. Briefly, COSO defines "risk" as any event that impedes the company from meeting an objective. So, the first steps for NFM reporting are:

Define Objectives

Management and the board set objectives for how the company creates, preserves and realizes value for its stakeholders. COSO groups objectives into four categories: strategy, operations, reporting and compliance. NFMs fall into one or more of these categories.

Say, for example, the company announces it will reduce carbon emissions by 50% by 2030. The objectives are both operational — reducing emissions — and reporting — accurately reporting the reduction.

Identity Risks

Risk identification is the cornerstone of effective NFM disclosure. Once the company sets its NFM objectives, it must then identify and respond to risks to achieving those objectives. Risk identification involves analysis of risk factors — e.g., internal/external, entity/transaction levels — and reasonably possible events and scenarios that arise from analysis.

For example, reducing carbon emissions poses operational risks of the company not achieving carbon emissions reduction targets and reporting erroneous disclosures — e.g., data manipulation.

Counsel serves a valuable role in defining objectives and identifying risks. Regarding objectives, lawyers are inherently equipped to challenge whether objectives are achievable and measurable. Counsels' company knowledge and interviewing skills are critical to identifying potential risk events and scenarios for risk identification.

2 Define the NFM dataset.

For some lawyers, data is intimidating and seemingly within the province of finance and technology professionals. Think of data as the information your company or client uses to support and calculate its NFMs. Defined datasets allow users to understand the data and make better-informed decisions.

The definition should include the following.

Population

The set of events, observations or instances with similar attributes that comprise the data used as the basis for determining the NFM. Counsel should ensure the company documents missing or incomplete information to allow users to decide whether the population is adequate for its intended purpose.

Data Elements

The fields or elements included in the individual records or members of a dataset. For example, to determine the diversity of employees, a dataset should consist of elements such as name or unique ID, age or date of birth, active or inactive employment status, gender, ethnicity, work location, title and remuneration.

Data Source

The manner the company created, accumulated and acquired the data. The nature of the source allows users to assess the reliability and consistency between reporting periods.

Units of Measurement

Some data has alternative units of measurement — e.g., metric versus. imperial or country monetary exchange rates.

Besides noting the unit of measure, counsel should ensure the company documents the level of precision — e.g., values rounded to nearest hundred, thousand or million. The nature of the NFM will dictate the level of required precision.

Data Scope Period

Counsel should make sure the company is clear about the time for which the dataset relates.

Attorneys should challenge the organization to ensure the dataset is valid, relevant, complete, consistent and accurate.

- Valid: Do the data and the elements of the data represent what they purport to represent?
- Relevant: Is the data used to determine an NFM consistent with the purpose of the NFM?
- Complete: Does the population include all data for the reporting period?
- Consistent: Are the definition of data population and methods used in measuring and calculating data consistent across reporting periods? If not, document and explain inconsistencies and restate prior NFMs to allow comparability to the NFM?
- Accurate: Does the data trace back to supporting evidence to ensure proper recording and allow for recalculation replication of results?

3 Develop a Process Map.

Counsel's next step is to have the company or client document the NFM lifecycle in a process map, a graphical representation of individual actions, events, operations and systems that comprise a process.

The key elements of a data lifecycle are:

- Create or acquire: Obtain data that either did not exist or did not exist previously within the organization.

- **Process:** Transform data so it can be analyzed.
- **Analyze:** Review data to describe facts, detect patterns, develop explanations and test hypotheses.
- **Preserve:** Set procedure for saving data so that it prevents intentional or unintentional changes or deletion.
- **Access:** Provide user-restricted access to data to aid in preparing or sharing it with employees, customers and regulators.

For each element, make sure the organization defines the objectives and processes to achieve those objectives. Defining the dataset definition, as described above, provides input into the objectives and processes for the initial create and acquire stage of the data lifecycle.

Counsel should make sure the company documents methods used to transform data to conduct analyses. Transformation methods include, for example, converting data from unstructured to structured data or extracting data from a human resource system to a spreadsheet.

The analyze stage can consist of a simple tabulation of amounts for the year to a customized model that estimates or projects amounts used to determine an NFM. If any data used in determining an NFM is based on an estimate or projection, it needs to be documented to ensure consistency of calculations from period to period.

4 Create an NFM key control activities inventory.

Control activities are policies, procedures and controls on which organizations rely to mitigate risks. Control activities can be preventive or detective and encompass a range of manual and automated activities, including authorizations, approvals, verifications, reconciliations and business performance reviews.

The inventory links control activities to identified NFM disclosure risks. Limit the inventory to key control activities — that is, control activities that reduce risk. To build a control activities inventory, the legal or other team reviews written policies and procedures that address the stages in the process map. To identify undocumented control activities, consider interviewing participants identified in the process map.

Besides listing control activities, the inventory should include the company's design assessment and operating effectiveness testing results. Design effectiveness considers whether the control activities, if operating as prescribed, adequately mitigates the risk. Operating effectiveness assesses whether the control activities operated as designed and the competency and authority of persons performing the control activity.

If the control activities have not been audited, have the company arrange for internal audit or an independent third party to assess design and test operating effectiveness to avoid overreliance on non-existent or ineffective control activities.

Failure to identify risks and overreliance on ineffective control activities are the common cause of improper NFM disclosures. We recommend adopting ICFR auditing standards to assess design and validate operating effectiveness.[2]

5 Fill the gaps now.

Chances are risk identification and control activities inventory will identify significant gaps — no control activity — and control activity deficiencies — design or operating effectiveness — in the reporting process for NFMs new to public disclosure. These gaps and weaknesses pose substantial risks which the company must remediate before making NFM disclosures.

Because remediation takes time and resources, make sure your company or client fills gaps now to prevent inaccurate NFM reporting.

Conclusion

Investors, stakeholders and regulators are forcing companies to become more transparent around the key performance indicators and metrics used by executives in managing the company and addressing their responsibilities around ESG mandates.

While the regulatory framework around ESG metrics is still in a state of flux, increased regulation around ESG and other NFMs is all but inevitable.

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[1] Committee of Sponsoring Organizations of the Treadway Commission (COSO) (available at https://www.coso.org).

[2] See generally Public Accounting Oversight Board, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, Auditing Standard 2201 (2007) (available at https://pcaobus.org/oversight/standards/auditing-standards/details/AS2201).