ESG Assurance: A Competitive Differentiator

BDO Explains Why ESG Assurance is Now a Competitive Imperative for All Companies, Large and Small

Sustainability is a powerful force in today's economy. McKinsey & Company estimates that companies will invest $5 trillion per year in sustainability by 2025. Business leaders increasingly see sustainability as pivotal to risk management and value creation.

In line with this trend, more and more companies are investing in third-party assurance for environmental, social, and governance (ESG) and sustainability reporting to mitigate risk and bring valuable benefits. Investing in ESG assurance can bring discipline to non-financial reporting, avoid greenwashing and help companies prepare for emerging regulations that will require objective reporting.

All companies have a role to play in ESG factors. For the moment, however, it is difficult to assess how businesses are achieving their ESG goals and whether their ESG reporting is credible. Although most large companies publish sustainability reports which reflect ESG data, they often are of limited utility because the information lacks the consistency, comparability and rigor associated with reporting of financial information.

That's where ESG assurance, also known as ESG attestation, comes in. In this article — one in a BDO series on ESG assurance — our experienced professionals provide an overview of what ESG assurance is and why companies should seriously consider engaging a reputable third-party to provide assurance on one or more components of their ESG reporting.

MORE ON BDO'S ESG ASSURANCE ARTICLE SERIES:

Learn more about the competitive importance of ESG assurance and considerations for companies seeking attestation on their ESG data through BDO's seven-part series of insights, which will cover the following topics:

- The Path to ESG Reporting and Attestation Readiness
- ESG Assurance: A Competitive Differentiator
- Limited or Reasonable Assurance for ESG Data — What is Right for You?*
- Challenges in the ESG Assurance Environment*
- Preparing Your Control Environment for ESG Reporting and Attestation*
- Managing Your ESG Data Towards Third-party Assurance*
- Sustainable Finance and ESG Assurance*

*Coming soon

Why is ESG assurance so critical today?

The driving forces behind increased attention on ESG assurance are varied and numerous. Demands for quality ESG information come from a variety of stakeholders, such as customers, regulators, investors and employees. The benefits of assurance over ESG data are similar to those of a financial audit, providing stakeholders with confidence in the quality of the ESG reporting, as well as providing insight into how an organization can enhance its related internal processes and controls.

Regardless of a company's ESG positioning, assurance will help ensure that the company's ESG reporting is ready when regulators phase-in additional reporting requirements. ESG initiatives are not a "one-and-done" activity; they are a constantly evolving exercise in refining sustainability efforts and adjusting goals. With this, a company's ESG reporting also evolves — it is an iterative process. ESG assurance helps to provide confidence in the quality and integrity of a company's reporting as it advances.

What are the key forces driving attention to ESG assurance?

Companies all over the world are investing time and money in their ESG efforts. There are many tailwinds behind the growing importance of ESG assurance, including:

- **Customers:** 65% of U.S. buyers consider sustainability when making purchases and globally, 89% have shifted their spending towards more sustainable goods and services in the past five years. Companies must respond to these major shifts in consumer preferences to remain competitive.
- **Investors:** With the massive amount of capital going into ESG investing and a growing list of ESG indexes and exchange-traded funds (ETFs), the data underpinning corporate sustainability claims is being closely scrutinized. Companies that subject themselves to rigorous reviews in the form of third-party assurance are expected to enjoy a credibility advantage.
- **Vendors:** Companies are increasingly incorporating upstream and downstream impacts in their ESG assessments and objectives, including carbon net-zero goals. As more organizations incorporate this data into their disclosures, their partners will be asked to provide data that has been attested to.
- **Competition:** Given the importance of ESG to businesses and consumers, assurance is becoming a competitive imperative. A company that falls behind its competitors in ESG reporting may lose favor with customers, employees and other partners as those stakeholders make decisions based on ESG-related factors.
- **Regulation:** Any company wishing to do business with a U.S. public company may soon need more advanced ESG reporting and assurance. This is because in March 2022, the U.S. Securities and Exchange Commission (SEC) proposed new rules that would require public companies to report greenhouse gas (GHG) emissions. This potentially includes value chain Scope 3 related emissions, as well as climate-related risks, and targets and transition plans relating to emissions reductions and other sustainability goals. The proposal includes assurance requirements regarding certain emissions disclosures.

  In addition to the SEC rules, in November 2022 the European Parliament passed new sustainability reporting requirements that apply to companies doing business in the European Union meeting certain size requirements. The measure states, "*To ensure companies are providing reliable information, they will be subject to independent auditing and certification. Financial and sustainability reporting will be on an equal footing and investors will have comparable and reliable data.*"
- **Greenwashing prevention:** Companies are increasingly being called out for greenwashing, or misrepresenting their sustainability credentials. Assurance can help companies bring transparency to their ESG metrics. ESG assurance aids in mitigating the risk of greenwashing accusations by ensuring that ESG data is accurately reported and by underscoring the credibility of the data. (See BDO's recent article, *Trends in fraud and financial investigations: Greenwashing*.)

How prevalent is ESG assurance?

Globally, about 58% of companies issue some form of ESG assurance, [according to a 2021 study] by the American Institute of Certified Public Accountants (AICPA), the International Federation of Accountants (IFAC), and the Chartered Institute of Management Accountants (CIMA). Many larger companies have been obtaining third-party assurance on elements of EGS data for years. The proportion is growing, although assurance so far has mainly addressed GHG emissions.

Another study, conducted by the Center for Audit Quality (CAQ), found similar results. In 2020, 464 of the companies in the S&P 500 Index issued a standalone ESG report and in excess of 60% of these companies obtained predominately limited assurance on certain components of their reported ESG information, [according to the CAQ study].

How robust is the ESG assurance process?

ESG assurance is akin to a financial audit or review conducted by a certified public accounting firm, but it covers a company's ESG data and related disclosures rather than financial statements and related footnotes. Like attestation of financial data, ESG assurance is carried out by a qualified independent firm, which issues a report upon completion of the review or examination.

The scope of ESG assurance can range from a single metric, such as greenhouse gas emissions, to a full sustainability report. Levels of assurance may be limited (also referred to as a review) or reasonable (also referred to as an examination). Assurance is generally issued in accordance with AT-C 105 Concepts Common to All Attestation Engagements, AT-C 210 Review Engagements, and AT-C 205 Assertion-Based Examination Engagements, promulgated by AICPA or in accordance with the International Standard on Assurance Engagements (ISAE) 3000 promulgated by the International Auditing and Assurance Standards Board.

What are the risks of not using ESG assurance services?

In the near-term, companies that fail to obtain assurance on their ESG performance could face:

Reputational damage | **Competitive risk** | **Vendor pressure** | **Customer attrition** | **Employee turnover and difficulty hiring** | **Compliance costs**

A delay in starting the ESG assurance process poses additional risks. ESG assurance requires selecting and hiring an audit firm and necessitates extensive planning if the work is to proceed smoothly, so it's a difficult process to execute on short notice. In addition, continuing to publish ESG data without assurance increases the risk that errors may be identified once a third-party is brought in to provide assurance. Beginning the ESG assurance process sooner and while under less stakeholder pressure may lead to a mitigation of these risks.

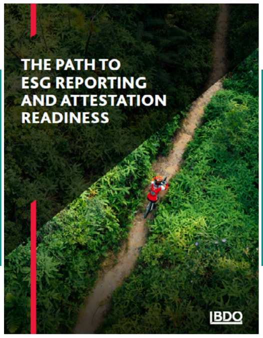
How should companies prepare for ESG assurance?

ESG assurance requires a methodical approach. A company should start by taking an inventory of the current state of its ESG reporting. This includes items such as:

- A materiality assessment and determination of metrics that are important to its stakeholders
- Review of ESG reporting provided by industry peers
- Consideration of reporting frameworks to be used
- Establishing management roles and responsibilities
- Board oversight
- Adequacy of processes and controls
- Resource sufficiency

Look for forthcoming deeper dives into each of these items in future insight editions.

After evaluating its current state, the company can identify areas where attention is needed to prepare for ESG Assurance. Typically, these include a focus on the processes and controls, availability of support for key estimates and evaluation of resources. The effort needed to prepare ESG data for the rigors of attestation should not be understated. While there are many similarities with the preparation needed for a financial statement audit, ESG data often involves collaboration between a broader group of functions within a company.



Preparing for ESG assurance is a complex undertaking that needs to be conducted in cooperation with an auditing firm. BDO reviews the considerations in more detail in **The Path to ESG Reporting and Attestation Readiness.**

Given the increasing importance of ESG and its edge as a competitive differentiator, companies will benefit from proactively seeking ESG assurance — especially during a downturn in the economy as organizations look to sustain themselves through a challenging economic climate. BDO will continue to produce a series of leading insights to help companies understand how they can leverage ESG and navigate the ESG assurance landscape. Executives are encouraged to follow this series for comprehensive, value-added insight covering the ESG landscape.

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