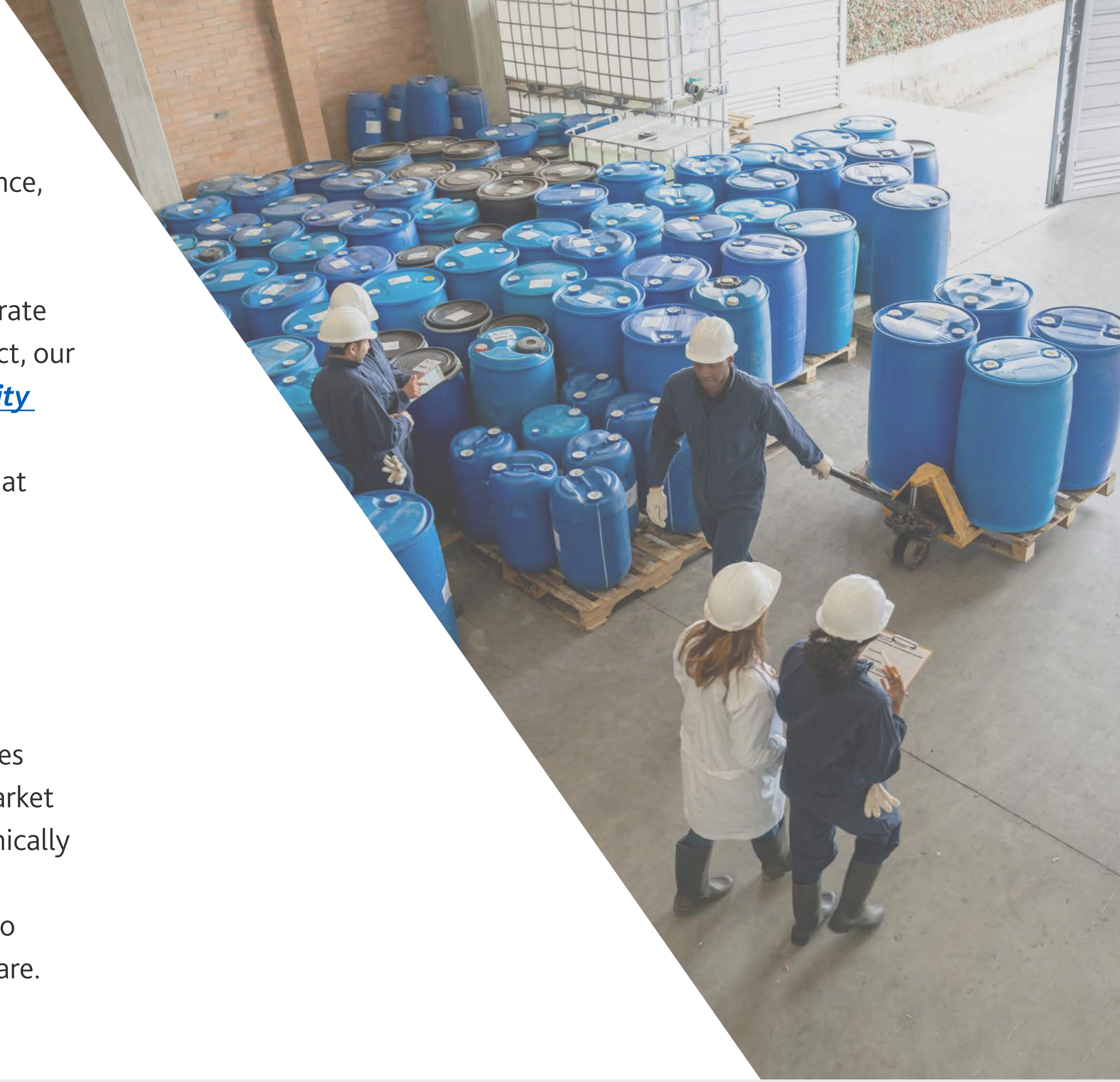
The Cascading Impact of ESG Reporting on Mid-sized Companies

Despite the rollback of some U.S. federal regulations and considerable political turbulence, the private sector continues to advance the integration of sustainability into their corporate strategies and reporting. In fact, our most recent ***CFO Sustainability Outlook Survey*** showed that 91 percent of organizations that are integrating sustainability strategically expect increased revenue in the coming year compared to just 74 percent of their peers.

Small and mid-sized companies are being impacted by this market trend, even if they don't technically fall under the scope of formal regulations. There are things to look out for and ways to prepare. **Read on to learn more.**



Why should smaller companies be concerned about sustainability reporting?

While some sustainability reporting regulations are being pulled back or are in the process of being revised, others at the state and international level continue to grow. Aside from regulatory mandates, most large, multinational companies continue to move forward with sustainability strategies, because they see clear business benefits in mitigating risk, creating value in their supply chains, and innovating for new products and new markets.

Smaller and mid-size companies are often suppliers to these large companies, and they're subject to cascading expectations to support decarbonization, human rights, and other sustainability goals, because the supply chain tends to be where the majority of emissions are generated, and where other externalities pose the greatest risks. Many supplier agreements now include requirements for providing greenhouse gas emissions and other environmental, social and governance (ESG) data, as well as plans for mitigating impact.

Other stakeholders are cascading these requirements as well. Banks and lenders are requiring ESG data as part of the terms of lending to support their own net zero strategies. Asset managers are measuring risks and value according to ESG factors, and private equity firms often require consistent ESG reporting across their portfolios. Companies looking to enter into any M&A transaction now should consider how their ESG data and practices line up with investor criteria, as poor ESG performance can impact deal pricing and terms.

Aside from the cascading impact of larger companies and stakeholders, smaller companies may come under the purview of some sustainability and ESG regulations, including industry-specific rules that can be easy to miss among the evolving landscape of laws at the state, national and international level. For example, **Canada's S-211** requires any company sourcing products from Canada or selling products in Canada to report its efforts to mitigate child and forced labor in the supply chains, with severe penalties for noncompliance. And a slew of Extended Producer Responsibility laws in U.S. states and in the EU require companies to manage the waste and disposal of their products through recycling, takeback or other means.

What are the most common categories of compliance?

No single regulation covers every aspect of sustainability and ESG compliance, though some are more comprehensive than others. Regulations in Europe and California cover greenhouse gas emissions for scopes 1, 2 and 3 – the entire value chain – for certain companies. But others require a smaller scope, or focus on qualitative risk-mitigation strategies rather than quantitative performance disclosures. Still others deal with supply chain responsibility, sourcing, or focus on the procurement of raw materials.

The reporting requirements we see most from clients are part of a double-materiality assessment, where companies determine the material relevance of ESG topics, including but not limited to the following categories:

Climate risk assessments

These can include greenhouse gas (GHG) emissions, net zero strategies and mitigation plans, as well as other categories like water and waste.

Supply chain sourcing

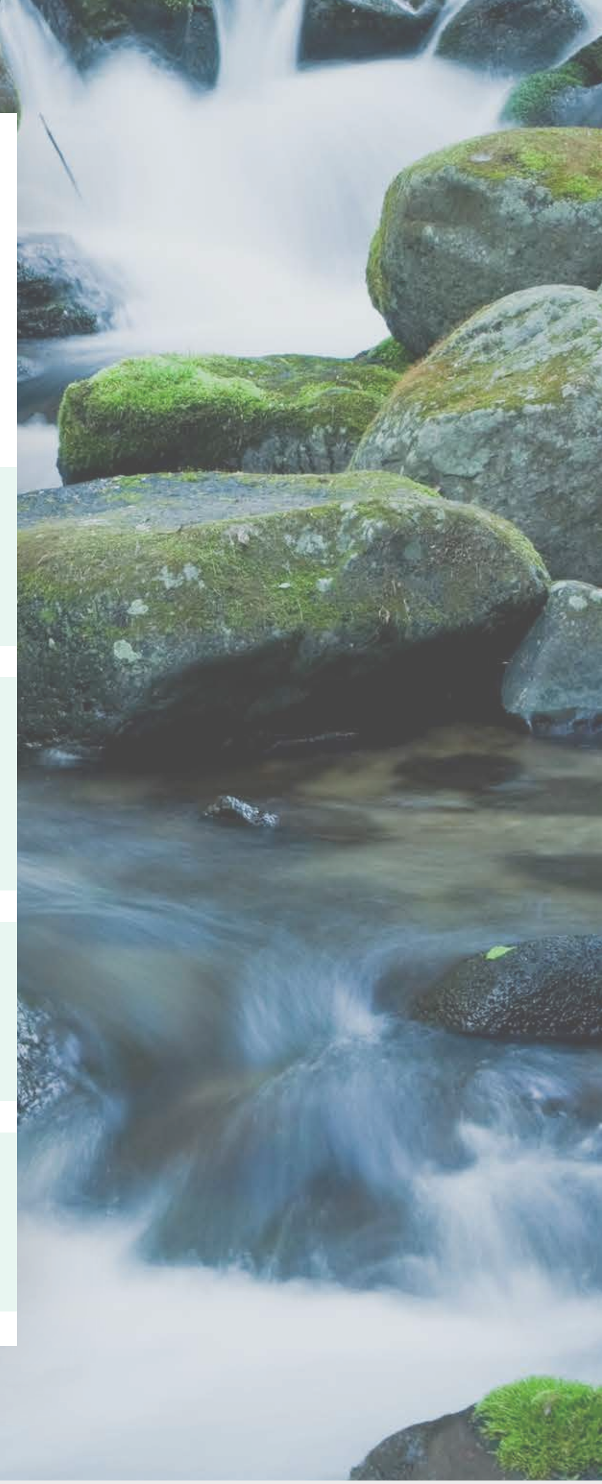
Supply chain requirements tend to focus on transparency and mapping of suppliers, and the traceability of products, packaging, manufacturing, and raw materials all the way to their source. They include requirements for policies and codes of conduct, and enforcement with suppliers.

Human rights

These requirements often encompass both child labor and forced labor in the supply chain, including the geographic origin of manufacture and components, especially when they come from certain countries and regions of the world.

Biodiversity

While standards are still emerging because impacts can be hard to quantify, there is an increasing focus on agricultural practices, impacts on ecosystems and biodiversity, and the depletion of natural resources and land.



How should small and mid-sized companies prepare?

Track your emissions. We see this as the number-one emerging requirement, and it can seem daunting to undertake the process of data collection and management. The good news is that there are standards and protocols, as well as data and automation tools that can facilitate the process and even turn your data into tools for smart decision-making that uncover commercial value. Other steps include:

- **Map your supply chain.**
  It may no longer be good enough to know only the first or second tier of your suppliers. Companies, regulators and consumers want to know the origin of your products and services. Increased transparency also provides better line-of-sight into potential risks and opportunities for cost optimization.
- **Create a supplier code of conduct.**
  Codes of conduct are a minimum standard that helps your suppliers understand your company's values and your expectations for doing business. There are many templates and best practices to emulate, though each should be customized for the organization's needs and requirements.
- **Plan for external reporting.**
  There may not be a clear timeline for when you will be required to publish disclosures on your website, in filings, in RFPs or in a sustainability report. But momentum is shifting in the direction of more reporting and more transparency. Even if you decide not to publish externally, it's helpful to begin collecting data and sharing internally, applying the same rigor you would for financial data, because some regulations will require third-party assurance, and some customers will require it.
- **Incorporate sustainability risks into ERM planning.**
  Sustainability and ESG should be considered in formal enterprise risk management, and not just as a standalone component, because these risks tend to be spread across multiple areas of the company. Sustainability and ERM teams should work together to improve efficiency and resilience for the organization.
- **Develop a sustainability strategy.**
  A piecemeal approach to sustainability initiatives will ultimately result in missed opportunities and unaddressed risks. It's critical to incorporate your efforts into a larger sustainability strategy that directly connects to your business goals. Each organization must determine which issues are most material to them and their stakeholders to help ensure they are focused on the right priorities and have a roadmap to get there.

The Cascading Effect

STAKEHOLDERS

- Large company supply chains
- Banks and lenders
- Asset managers and private equity
- Government regulators

COMPLIANCE CRITERIA

- Company size
- Geography
- Industry
- Sourcing
- Manufacturing
- Logistics
- Product end use

COMMON REQUIREMENTS

- Climate risk assessments
- Supply chain sourcing
- Human rights
- Biodiversity

PREPARING

- Track your emissions.
- Map your supply chain.
- Create a supplier code of conduct.
- Plan for external reporting.
- Incorporate sustainability risks into ERM planning.
- Develop a sustainability strategy.

How BDO Can Help

Our experienced professionals can provide a complimentary regulations and reporting gap assessment to help you identify the greatest risks and opportunities for your organization, based on your size, your industry and your current sustainability approach.

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