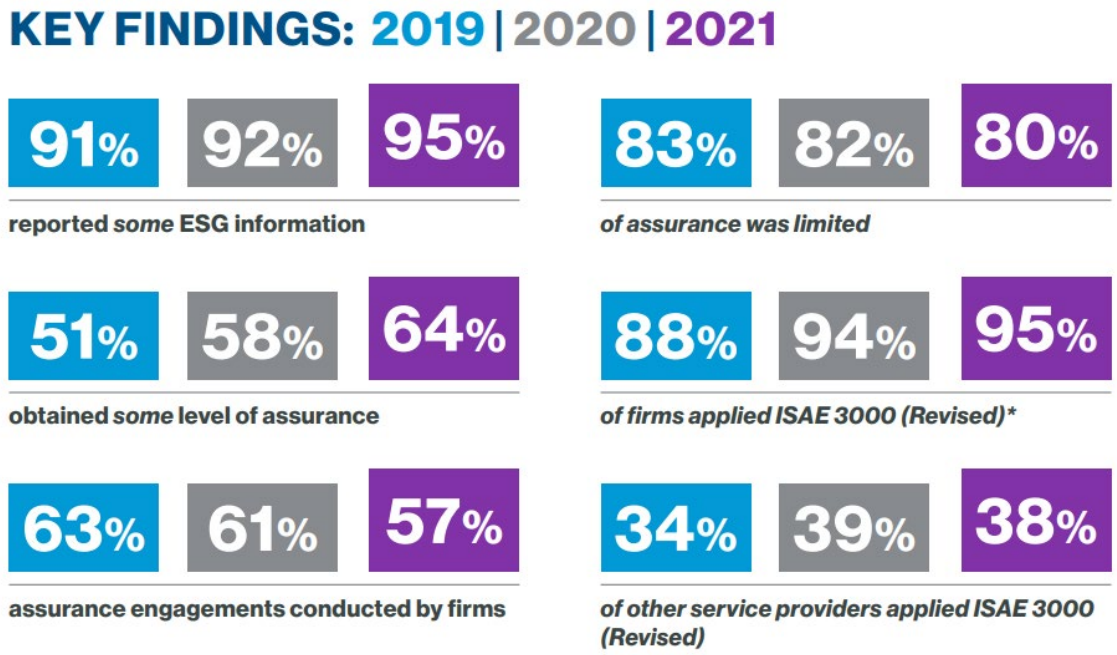
1Q 2023 ESG Regulation & Financial Statement Updates

As the first quarter closes out without a final climate disclosure rule from the SEC, European standard setters are aggressively moving forward on a January 2024 effective date for their environmental, social, and governance (ESG) disclosure framework. A President Biden executive order has resulted in proposed changes to federal contractor requirements that are even stricter than the SEC proposal. At the same time, the new legislative session in Washington, D.C., begins with fresh pushback against ESG regulation. Here are the latest updates through March 22, 2023.

A. Current State of Reporting & Assurance

The American Institute of CPAs (AICPA) and the Chartered Institute of Management Accountants (CIMA), together with the International Federation of Accountants, recently released a benchmarking study of global practice in sustainability disclosure and its assurance. Almost all large companies now report on ESG, but the continued use of multiple standards and frameworks makes comparability across companies, industries, and countries challenging. The study noted that 86% of companies use or reference more than one reporting framework. The rate of assurance on ESG disclosures increased to 53% on all four of the categories examined (greenhouse gas (GHG), other environmental, social, and governance) in 2021 and 64% received assurance on some but not all of the categories.



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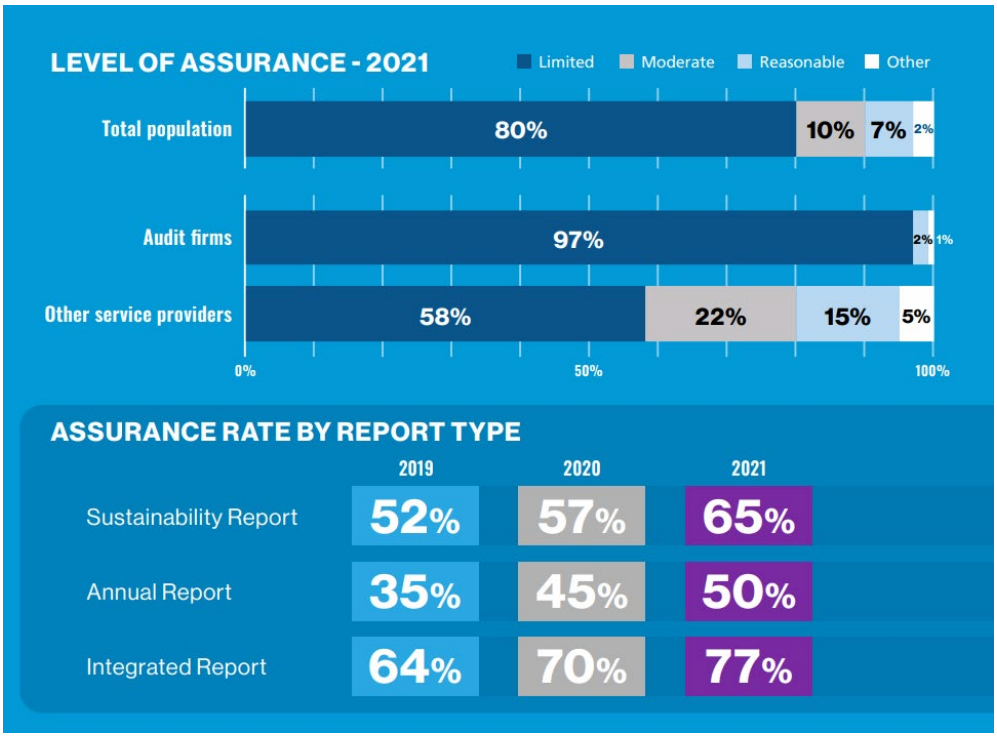

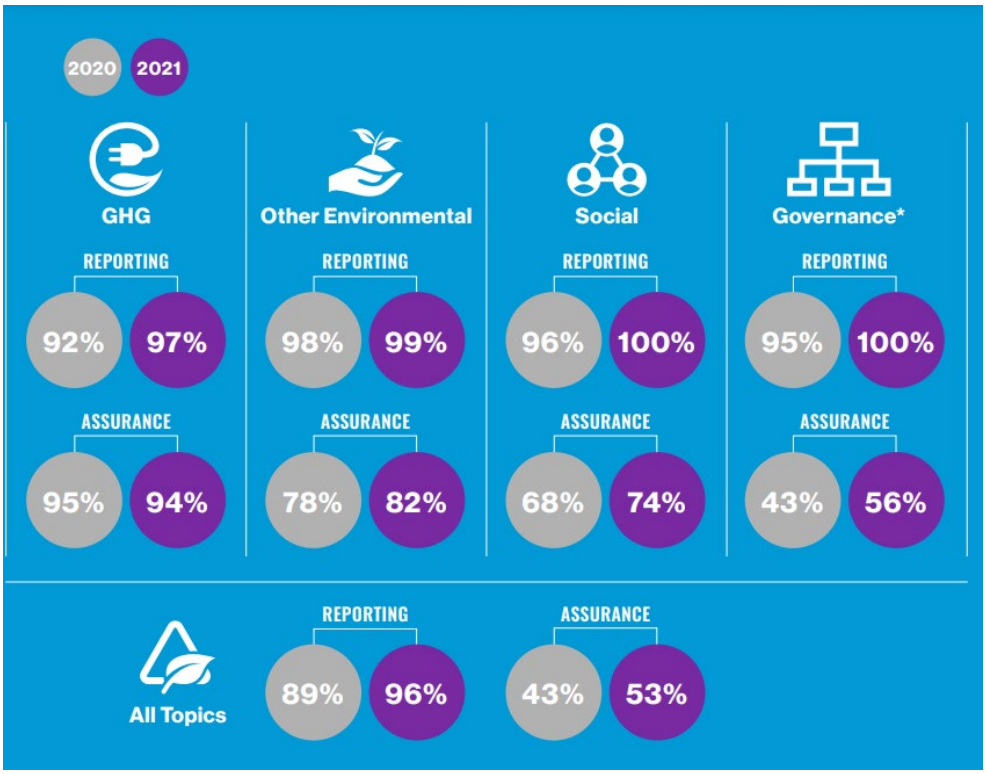

Source: IFAC, AICPA & CIMA: The State of Play: Sustainability Disclosures & Assurance, 2019-2021 Trends & Analysis

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B. U.S. Updates

Federal Acquisition Regulatory Council (FAR Council)

In May 2021, the Biden administration issued Executive Order 14030 requiring major federal suppliers to publicly disclose greenhouse gas (GHG) emissions and climate-related financial risk and set science-based reduction targets. To comply, the FAR Council proposed rulemaking in November 2022 to require major federal contractors to disclose:

- Scope 1, Scope 2, and relevant Scope 3 GHG emissions
- Annual climate disclosure based on the Task Force on Climate-Related Financial Disclosures (TCFD) framework
- GHG reduction targets established and validated by the Science Based Targets initiative (SBTi)

Major contractors without existing targets would be required to establish them. Smaller “significant” contractors would not be required to submit the annual TCFD climate disclosure or establish science-based reduction targets but would be required to provide disclosure of Scope 1 and Scope 2 GHG emissions. Major contractors are those receiving more than $50 million in federal contracts, while “significant” contractors are those receiving from $7.5 million to $50 million in federal contracts. These thresholds are based on the size of contracts awarded and not on related revenue in any given year.

There are limited exceptions for certain colleges and universities, nonprofit research entities, state or local governments, and an Alaska Native Corporation, a community development corporation, an American Indian tribe, a Native Hawaiian Organization, or a tribally owned concern.

The rules would be effective one year after publication of a final rule and have staggered compliance dates. One year after publication of a final rule, a significant or major contractor must have completed a GHG inventory, and the significant or major contractor must have disclosed the total annual Scope 1 and Scope 2 emissions from its most recent inventory in System for Award Management (SAM). The compliance requirements for major contractors will start two years after publication of a final rule to allow additional time to complete a GHG inventory that covers Scope 3 emissions; conduct a climate risk assessment and identify risks; complete the Carbon Disclosure Project (CDP) Climate Change Questionnaire; and commit to, develop, and obtain SBTi validation of a science-based target.

The comment period was reopened from January 13, 2023 to February 13, 2023.

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Federal Contractors		Federal Supplier Climate Risks and Resilience Proposed Rule Requirements		
Segment	Annual Federal Obligations	Scope 1, Scope 2, and relevant categories of Scope 3 emissions in alignment with the GHG Protocol Corporate Standard	Climate Risks assessed in alignment with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD)	Emissions reduction target validated by the Science Based Targets Initiative (SBTi)
Major Contractors	>$50M	Yes (through CDP)	Yes (through CDP)	Yes (through SBTi)
Significant Contractors	>$7.5M-$50M	Yes (Scope 1 and Scope 2 only)	No	No
Other Contractors	<$7.5M	No	No	No

Source: Office of the Federal Chief Sustainability Officer

U.S. Department of Labor (DOL)

In March 2023, both the U.S. Senate (50-46) and the House (216-204) voted to overthrow a recently enacted DOL rule using the *Congressional Review Act*. This allows lawmakers to overturn a newly issued regulation on an expedited schedule with a simple majority vote, rather than the 60 votes needed to advance most legislation. As widely expected, President Biden vetoed the bill on March 20, 2023, but the makeup of the legislative branch could slow future climate change efforts.

In November 2022, the DOL issued a final rule that requires a fiduciary to consider all relevant factors in investment decisions, including selecting qualified default investment alternatives (QDIAs); exercising shareholder rights, such as proxy voting; and the use of written proxy voting policies and guidelines. This reverses a November 2020 final rule, "Financial Factors in Selecting Plan Investments," issued under the Trump administration, which generally required plan fiduciaries to select investments based solely on consideration of pecuniary factors. One of the 2020 amendments *prohibited* adding or retaining any investment fund, product, or model portfolio as a QDIA if the fund, product, or model portfolio includes even one non-pecuniary objective in its principal investment strategies. In January 2021, five days after the effective date of the "Financial Factors in Selecting Plan Investments," President Biden signed an executive order, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis." Agencies were directed to review all rules issued under the Trump administration to ensure they complied with the nation's "abiding commitment to empower our workers and communities; promote and protect our public health and the environment." The DOL announced that pending review, no enforcement actions would be taken against any plan fiduciary that failed to comply with the November 2020 final rule. The DOL was concerned that the 2020 rule created a perception that fiduciaries are at risk if they included any ESG factors in the financial evaluation of plan investments, and that they would need to have special justifications for even ordinary exercises of shareholder rights.

Resource: New DOL ESG Rules for ERISA Plans

SEC

On January 4, 2023, the SEC's semi-annual regulatory agenda was released. The agenda outlines the SEC's rulemaking priorities for 2023, listing 23 proposed rules and 29 final rules, and includes the following ESG-related topics:

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Proposals

- Corporate board diversity
- Human capital management
- Payments by resource extraction issuers

Final Rules

- Climate change disclosures (registrants). **Resource**: SEC's ESG Climate Proposal – What You Need to Know
- ESG investment practices (funds and advisers). **Resource**: Investment Advisers & Companies Face New ESG Disclosures
- Investment company names. **Resource:** SEC Lays Out ESG Reporting Expectations
- Cybersecurity (registrants). **Resource:** Public Companies Face New Cybersecurity Rules
- Cybersecurity (funds). **Resource:** SEC to Beef Up Cyber Rules & Disclosures

Category	Common Disclosure Topics
Environmental	▪ GHG Emissions ▪ Energy Consumption ▪ Water Usage ▪ Waste Generation ▪ Targets/goals related to the above metrics
Social	▪ Diversity and Inclusion ▪ Human Capital ▪ Data Privacy and Security ▪ Community Impact ▪ Workplace Safety
Governance	▪ Board Diversity ▪ Executive Pay ▪ Risk Assessment Process ▪ Business Ethics

In the absence of a final rule, registrants should continue to follow the SEC's 2010 interpretive guidance (see Appendix).

Federal Reserve Board (Fed)

In a January 2023 speech, Fed Chair Jerome Powell clarified the Fed's role on climate change: "Decisions about policies to directly address climate change should be made by the elected branches of government and thus reflect the public's will as expressed through elections. … The public reasonably expects supervisors to require that banks understand, and appropriately manage, their material risks, including the financial risks of climate change. But without explicit congressional legislation, it would be inappropriate for us to use our monetary policy or supervisory tools to promote a greener economy or to achieve other climate-based goals. We are not, and will not be, a 'climate policymaker.'"

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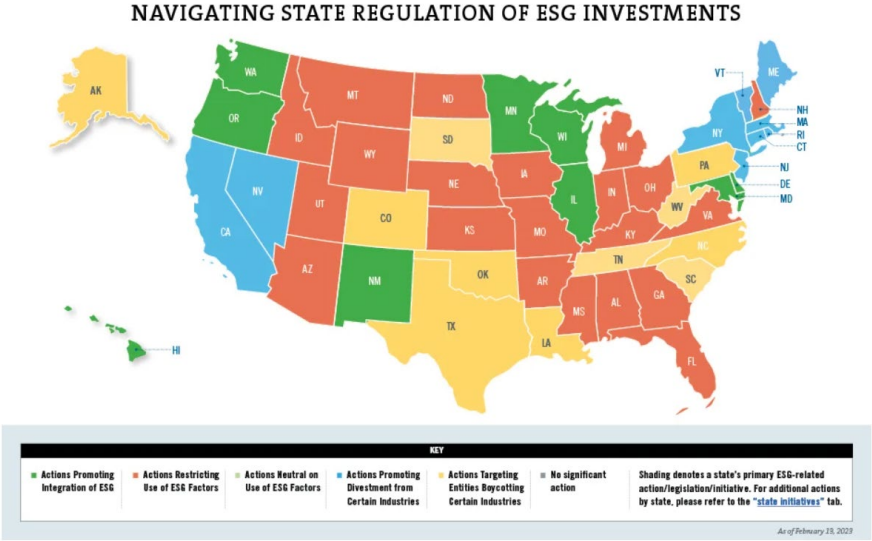
Climate Scenario Analysis

In September 2022, the Fed announced six large banks[1] would participate in a 2023 pilot climate scenario analysis exercise designed to enhance the ability of supervisors and banks to measure and manage climate-related financial risks. This climate scenario analysis is separate from bank stress tests with no capital consequences. In January, the Fed released further details. The pilot exercise includes physical risk scenarios with different levels of severity affecting residential and commercial real estate portfolios in the Northeastern U.S. and directs each bank to consider the impact of additional physical risk shocks for their real estate portfolios in another region of the country. For transition risks, banks will consider the impact on corporate loans and commercial real estate portfolios using a scenario based on current policies and one based on reaching net zero GHG emissions by 2050.

Results must be submitted by July 31, 2023. Insights gained from the pilot are expected to be published in aggregate to help identify potential risks and promote risk management practices (no bank-specific information will be released).

State Level

State legislatures continue to propose and pass legislation limiting efforts that can be related to ESG. In August 2022, Florida Gov. Ron DeSantis' administration approved a resolution to bar the state's $186 billion pension fund from considering non-economic factors when making investment decisions.[2] Texas and West Virginia have both banned additional banks and investment funds for allegedly boycotting fossil fuel-based energy companies critical to each state's economy. On February 23, 2023, the Indiana House adopted House Bill 1008, which would require the $45 billion Indiana State Public Retirement System to make investment decisions "solely in the financial interest of the participants and beneficiaries of the public pension system." The bill defines "furthering a social, political, or ideological interest" as pursuing a reduction in GHG emissions beyond legal requirements and for nonfinancial purposes, assessing corporate boards based on characteristics of a protected class (such as race, sex, or age), and divesting from companies in a list of protected industries (firearms, oil, gas, lumber, mining, agriculture, and meat production). The bill also requires the pension fund to track and report all of its proxy votes, roughly 200,000 annually.



[1] Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo

[2] S&P Global Market Intelligence, August 24, 2022

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Source: Ropes & Gray

C. European Developments

International Sustainability Standards Board (ISSB)

The ISSB continues efforts to finalize and issue the first two ESG financial reporting standards (climate and sustainability) by end of the second quarter 2023. At the ISSB's January meetings, board members voted unanimously for two proposals that would provide some relief on reporting for certain sustainability issues. At the February 16 meeting, the ISSB agreed that its initial IFRS Sustainability Disclosure Standards, S1 and S2, will become effective starting January 2024.

Reasonable & Supportable

The first proposal[3] would add a concept of "reasonable and supportable information that is available at the reporting date without undue cost or effort." This concept would not exempt entities from disclosure but would provide clarity about the information that entities would use in the preparation of disclosures. This concept would apply only to certain disclosures:

- Material information about a company's sustainability-related and climate-related risks and opportunities and their impacts on financial position and cash flows
- Value chain
- GHG emissions
- Climate-related scenario analysis
- Calculation of metrics on vulnerability to transition and physical risks

In general, for each of the above items:

- Disclosure should not be based on information that is unsupportable or unreasonable.
- Entities are required to use information that is available to them (including historical experience, current information, and forecasts of future conditions). This does include information that was not available at the reporting date.
- Entities are not expected to perform an exhaustive search for information if it would represent "undue cost or effort."

Commercially Sensitive Information

The second proposal[3] addressed feedback from the March 2022 proposals concerned that disclosure of commercially sensitive information could reveal too much detail on corporate strategy and planned actions, undermining a company's competitive advantage or/and enabling competitors to reverse-engineer strategic decisions and obtain deep insights into the company's strategy or gain a direct competitive advantage. The ISSB approved an exemption that would permit entities, in limited circumstances where information is not already publicly available, to exclude information about a sustainability-related opportunity when the information is commercially sensitive. If the exemption is used, an entity also must comply with the following requirements:

- Entities must identify a specific reason for nondisclosure of information, and to qualify for the exemption, the information must provide an entity with an economic benefit that translates to a competitive advantage because the information is not publicly available.

[3] IFRS Sustainability Staff Paper, ISSB meeting, ifrs.org, January 2023

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- By item of information omitted, disclose the fact that information has been omitted, and the general reason why the information has been omitted.
- Reassess whether the information qualifies for the exemption from disclosure at each reporting date.

In addition, the ISSB approved a number of other minor modifications intended to provide further clarity and granularity on reporting requirements.

Once the first two standards are issued, the ISSB will begin work on the next two topics—biodiversity and human rights.

Conclusion

Whether you are publicly traded or privately held, **FORVIS** can help provide an independent and objective view into your financial reporting. We leverage the latest technologies and process automation tools to provide companies assurance on their financial statements to help meet stakeholders' needs. For more information, visit forvis.com.

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Appendix – Existing 2010 SEC Guidance

The 2010 document highlights the following existing requirements of Regulation S-K and S-X that may require disclosure related to climate change:

- **Description of business**. Regulation S-X Item 101 expressly requires disclosure regarding the costs of complying with environmental laws.

- **Legal proceedings**. Regulation S-K Item 103 notes the federal, state, or local provisions that have been enacted regulating the environmental discharge or protecting the environment will not be excluded from disclosure under the "ordinary routine litigation incidental to the business" safe harbor and must be described if:

  - Such proceeding is material to the registrant's business or financial condition
  - Such proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges, or charges to income and the amount exceeds 10% of the registrant's current assets on a consolidated basis
  - A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than $100,000

- **Risk factors**. Regulation S-K Item 503(c) requires a discussion of the most significant factors that make an investment in the registrant speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular registrant; registrants should not present risks that could apply to any issuer or any offering. Registrants should consider specific risks they face as a result of climate change legislation or regulation and avoid generic risk factor disclosure that could apply to any company. For example, registrants that are particularly sensitive to GHG regulation, *e.g.*, the energy sector, may face significantly different risks from climate change regulation compared to registrants that currently are reliant on products that emit GHGs, *e.g.*, the transportation sector.

  Registrants whose businesses may be vulnerable to severe weather or climate-related events should consider disclosing material risks of—or consequences from—such events in their publicly filed disclosure documents. Significant physical effects of climate change, such as effects on the severity of weather, *e.g.*, floods or hurricanes, sea levels, the arability of farmland, and water availability and quality, have the potential to affect a registrant's operations and results. Possible consequences of severe weather could include:

  - For registrants with operations concentrated on coastlines, property damage and disruptions to operations, including manufacturing operations or the transport of manufactured products
  - Indirect financial and operational effects from disruptions to the operations of major customers or suppliers from severe weather, such as hurricanes or floods
  - Increased insurance claims and liabilities for insurance and reinsurance companies
  - Decreased agricultural production capacity in areas affected by drought or other weather-related changes
  - Increased insurance premiums and deductibles, or a decrease in the availability of coverage, for registrants with plants or operations in areas subject to severe weather

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- **MD&A**. Regulation S-K Item 303 requires that disclosure decisions concerning trends, demands, commitments, events, and uncertainties generally should involve the:
    - Consideration of financial, operational, and other information known to the registrant
    - Identification, based on this information, of known trends and uncertainties
    - Assessment of whether these trends and uncertainties will have—or are reasonably likely to have—a material effect on the registrant's liquidity, capital resources, or results of operations. Registrants also should consider—and disclose when material—the effect on their business of treaties or international accords relating to climate change. Registrants whose businesses are reasonably likely to be affected by such agreements should monitor the progress of potential agreements and consider materiality and the above principles

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