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Do ESG Matters Affect Accounting and Financial Reporting Today?

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Introduction

These days, it's hard not to find some mention of environmental, social, and governance (ESG) matters in the news. Discussions often focus on how ESG matters will affect a company's business strategy, operations, and long-term value. However, many of these discussions fail to mention any related impact on a company's *current* accounting conclusions and financial reporting. Accordingly, questions have arisen about whether a company needs to incorporate ESG considerations when preparing its financial statements. The answer is *yes*.

This publication examines certain potential effects of ESG matters on a company's financial accounting and reporting in the context of the *existing* accounting guidance and the *current* regulatory environment. While these effects will vary depending on the company's industry along with factors such as relevant regulatory, legal, and contractual obligations, all entities should evaluate ESG-related financial accounting and reporting implications.

Accounting Considerations

In response to questions raised by investors, credit rating agencies, lenders, financial statement preparers, regulators, policy makers, and other interested parties about the accounting and financial reporting considerations related to ESG matters, on March 19, 2021, the FASB staff published an educational paper, *Intersection of Environmental, Social, and Governance Matters With Financial Accounting Standards* (the "FASB ESG Paper"). The purpose of the FASB ESG Paper is to highlight the connection between ESG matters and their direct or indirect effect on the financial statements. Further, the FASB ESG Paper gives examples illustrating how an entity may consider the effects of material ESG matters when applying existing accounting standards.

The FASB staff observed that many current accounting standards require an entity to consider "changes in its business and operating environment when those changes have a material direct or indirect effect on the financial statements and notes thereto." Often, these considerations are related to aspects of accounting for which management judgment and estimation are required. The examples[1] below illustrate certain ESG matters that may materially affect an aspect of management judgment or estimation, ultimately resulting in a direct or indirect impact on the financial statements and notes to the financial statements.

Example 1

Impairment of Goodwill and Indefinite-Lived Intangible Assets

Under current accounting standards, goodwill and indefinite-lived intangible assets (e.g., trade names) are generally not amortized but are instead tested for impairment at least annually or more frequently if impairment indicators exist.

The direct or indirect effects of an ESG matter could give rise to an impairment indicator (e.g., changes in hazardous waste management regulations that adversely affect an entity's operations). ESG matters may also affect the measurement of an impairment loss when, for example, the matter materially affects the assumptions used to calculate the fair value of the reporting unit associated with goodwill or the fair value of the indefinite-lived intangible asset.

Example 2

Useful Lives of Finite-Lived Intangible Assets and Property, Plant, and Equipment

Current accounting standards require an entity to amortize a finite-lived intangible asset (e.g., client relationships or developed technologies) and property, plant, and equipment over its useful life, which is the period in which the asset is expected to contribute directly or indirectly to an entity's cash flows. An entity is required to evaluate the remaining useful life as of each reporting period and reflect any changes to the estimate in the financial statements prospectively.

The effect of an environmental matter may be one of many factors that affect the estimated useful life of a finite-lived intangible asset or property, plant, and equipment. For example, an entity may develop a more energy-efficient product to substitute a legacy product, resulting in a change in the estimated useful life of the client relationship intangible asset associated with the legacy product. In addition, if the equipment used to manufacture the legacy product will be phased out in favor of new equipment, a change in the estimated useful life of the equipment may likewise be required.

Example 3

Inventory

Under current accounting standards, inventory is often valued at the lower of cost and net realizable value[2] (i.e., the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation).

When estimating net realizable value, management is required to consider all relevant facts and circumstances. Estimates of net realizable value could be materially affected by, for example, a regulatory change that renders inventories obsolete, a significant weather event that causes physical damage to inventories, a decrease in demand for an entity's goods resulting from changes in consumer behavior, or an increase in completion costs because of raw material sourcing constraints.

[1] Examples are based on examples provided in the FASB ESG Paper.

[2] For inventory measured by using the last in, first out or the retail inventory method, the inventory is valued at the lower of cost or market.

Financial Reporting Considerations

Like the FASB, the SEC has been active in evaluating the impacts of ESG matters on accounting and financial reporting, issuing several public statements in the first quarter of 2021 to emphasize the importance of ESG disclosures to investors and the capital markets. In short, the SEC activities outlined below all point to the Commission's increased attention on (1) how companies apply existing rules to account for ESG risks and impacts to their business and (2) ESG disclosures based on existing SEC requirements. As a result of the SEC's publicly announced focus on ESG matters, we believe that an increase in SEC comment letters related to ESG matters is likely. The following is a summary of the SEC's recent ESG-related activities:

- On February 24, 2021, Acting SEC Chair Allison Herren Lee issued a statement directing the SEC's Division of Corporation Finance to increase its focus on climate-related disclosures when reviewing public-company filings, including assessing the extent to which public companies have disclosed information that is consistent with the SEC's 2010 interpretive release *Commission Guidance Regarding Disclosure Related to Climate Change*. The same week, the SEC issued an investor bulletin designed to educate investors about ESG funds.
- On March 4, 2021, the SEC announced the formation of the Climate and ESG Task Force in the Division of Enforcement, which will initially focus on identifying any "material gaps or misstatements in issuers' disclosure of climate risks under existing rules" as well as compliance issues related to investment advisers' and funds' ESG strategies. This announcement mirrors the SEC's Division of Examinations 2021 examination priorities, which include a focus on registered investment advisers and funds that concentrate on sustainability (or that use similar descriptions, such as sustainable, socially responsible, impact, or ESG-conscious).
- On March 15, 2021, Acting Chair Lee gave a speech regarding the SEC's role in ensuring that investors have access to reliable, comparable information on climate change and other ESG matters. Acting Chair Lee also raised the idea of establishing a U.S. sustainability standard setter, noting that "[o]ne potential path that we should consider is the development of a dedicated standard setter for ESG (similar to FASB) under SEC oversight to devise an ESG reporting framework that would complement our financial reporting framework." In addition to those related to climate, potential disclosure topics specifically mentioned by Acting Chair Lee include worker safety, human capital (including workplace and board diversity), human rights, and political spending. She also suggested that the SEC's role in addressing ESG matters expands beyond disclosure and includes considerations related to shareholder proposals and proxy voting processes.
- Also on March 15, 2021, Acting Chair Lee issued a request for input on climate-change disclosures, which is intended to help the SEC staff evaluate SEC disclosure rules "with an eye toward facilitating the disclosure of consistent, comparable, and reliable information on climate change." To meet these objectives, respondents are encouraged to consider the SEC's existing disclosure requirements as well as possible new disclosure requirements and disclosure frameworks. The SEC is interested in feedback from investors, companies, and other market participants on the topic and does not require a specific format for the submission of comments. Feedback can be provided on the SEC's Web site or by e-mail and is due by June 13, 2021.

Other ESG Resources

For additional information about ESG matters, see the following publications:

- Deloitte's *Defining the Role of the Audit Committee in Overseeing ESG*.
- Deloitte's *Heads Up* "Human Capital Measures Up."
- Deloitte's *Heads Up* "Enhancing Trust in ESG Disclosures."
- Deloitte's *Heads Up* "SEC Requests Input on Climate-Related and Other ESG Disclosures."
- The Center for Audit Quality's *The Role of Auditors in Company-Prepared ESG Information: A Deeper Dive on Assurance*.

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