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THE CUBICAL

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A Guided *ESG* Tour Through a 10-K Annual Report

Publicly traded companies have been issuing sustainability reports for at least 20 years. As the popularity of Environmental, Social, & Governance (ESG) investing has advanced in recent years, the number of annual sustainability reports has grown exponentially. However, at the same time, risks associated with such practices have begun to emerge. Such risks include: (i) doing nothing; (ii) failing to meet the investors in terms of the scope and scale of ESG commitments; (iii) failure to achieve ESG goals; and (iv) making misleading statements or engaging in other noncompliance behavior with respect to ESG goals.

Reviewing a company's sustainability reports is key to understanding its sustainability commitment and performance. However, as the focus on ESG increases, publicly traded companies are providing more and more detail about the business opportunities and risks associated with ESG in their annual 10-K financial report. Moreover, because annual reports are thoroughly regulated by the Securities and Exchange Commission (SEC), they provide a standardized framework through which such disclosures can be viewed and understood. This is not only useful for investors, but also for other organizations who are trying to understand the potential opportunities and risks associated with the ESG goals they are trying to set for themselves.

This edition of The Cubical touches on some of the areas of a 10-K where one would expect to find a discussion about the opportunities and risks associated with a company's ESG goals. (Since this is an environmental newsletter, the focus will be on the "E" in "ESG.") A review of these areas for a small sample of 10-Ks can give one a general sense of how companies think about their opportunities and risks. It should also provide one with a sense of what these companies are doing to leverage such opportunities and manage such risks.

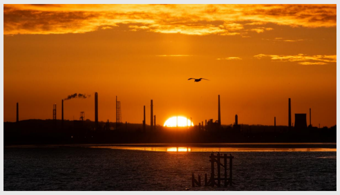
Taking Care of Business

Every 10-K annual report starts with a narrative describing of the company's business. (This narrative is found in Item 1 of the 10-K.) This narrative will typically include a description of the following: The company's products and services; Its subsidiaries and business segments; The markets in which it operates and its competition; Its human capital resources; The laws and regulations - including environmental laws and regulations - that apply to its operations.

In recent years, many publicly traded companies have begun to include a description of ESG commitments in this section. There are a variety of different approaches when it comes to such descriptions. Some companies have devoted an entire section to a discussion of ESG commitments. Others have included a sustainability narrative within a broader discussion about environmental laws and regulations. Finally, ESG and sustainability narratives have been incorporated into descriptions of new business segments that have been created to pursue opportunities in sustainability-related or low-carbon intensity markets.

In contrast to other sections of a 10-K, publicly traded companies have a relatively free hand in this section to tout their ESG commitments and achievements. For this reason, the ESG narrative in the business description section of a 10-K tends to serve as an abstract or executive summary of an annual sustainability report. Companies may lay out their ESG goals or core values, but they usually do not dive deeply into sustainability metrics or specific milestones. For such detail, the reader is invited to consult the annual sustainability report.

It can be quite illuminating to see a company's ESG narrative in the context of a broader discussion of the company's business. It provides a useful framework for tackling other sections of the 10-K that dive more deeply into the company's ESG-related business opportunities and risks.



What If ...?

Or to be more precise, what if a publicly traded company fails to achieve its own ESG goals? Many ESG goals that companies have set for

ESG Risk Factors

The quickest way to get a firm handle on how a publicly traded company views its ESG-related risks is to review the discussion of the company's risk factors in its 10-K annual report. Other than perhaps a slide deck for an investor's day conference, the Risk Factors contained in Item 1A of a 10-K is probably the most valuable source of information for gaining a general understanding a company's business operations. In my opinion, it is even more valuable than the general description of the business in Item 1. Risk Factors includes information about the company's most significant risks. The focus is on the risks themselves; not how such risks are being addressed by the company.

So, what ESG risks are being raised in the Risk Factors section of 10-Ks? A quick sampling of a handful of the 10-Ks for some of the nation's largest publicly traded companies for Fiscal Year 2021 reveals a wide variety of ESG-related risks. Broadly speaking, these risks can be grouped into the following six categories: (i) legislative and regulatory risks; (ii) risks associated with shifting customer preferences; (iii) risks associated with pressure being exerted by the capital markets; (iv) risks associated with energy supply; (v) physical impacts due to changes in weather patterns brought on by climate change; and finally (vi) risks associated with the company's efforts to achieve its own ESG goals.

Of these, the risks associated with shifting customer and investor preferences are perhaps most notable. Companies in a number of industrial sectors have identified the demand for less carbon-intensive product offerings as a risk factor. This issue has taken on particular significance in the automotive sector where even long-established auto manufacturers face the challenge of managing a transition from internal combustion engine (ICE) vehicles to electromotive vehicles (EVs).

Similarly, the increasing preference for less carbon-intensive business models from investors has been identified as a risk factor. In particular, publicly traded companies in the fossil fuel sector have identified and discussed this risk. Increasing divestment from their sector may increase the cost of borrowing or otherwise result in limits on funding. In addition, such divestment may result in a decrease in the market value of their securities,

themselves are ambitious, to say the least. The achievement of such goals may depend on unforeseen breakthroughs in technology and business solutions, or factors that are just simply beyond the company's control.

At least one publicly traded company in the fossil fuels sector identifies this particular risk in its 10-K and discusses it at some length. This company, which has established a goal of achieving a goal of net-zero by 2040 notes that new technologies will need to be developed if it hopes to achieve this goal. It then goes on to say that its ability to achieve such breakthroughs may be hampered by an ability to gain access to capital in a market environment where investors have soured on its industry.

Failure may not be an option, but in many cases, it is a possibility that cannot be ignored. The prospect and ramifications of failure are not only concerns for publicly traded companies. Any business that establishes, publicizes, and then fails to achieve ESG goals may suffer irreparable harms to its business and reputation. Businesses of all shapes and sizes should prepare for such contingencies.

There aren't any easy solutions to address this concern. Even a modest course correction in a company's ESG goals carries business and reputational risks. One possible solution though is to establish an early warning system. If a company is going to be faced with the prospect of adjusting its ESG goals, the potential impacts associated with such adjustments can be which in turn would result in an increase in the cost of capital. Finally, values of carbon-intensive assets may be reduced due to less demand.

It is important to remember that the 10-K annual report is the product of a thorough, exhaustive, and iterative internal review process. There are no wasted words in such a report. For this reason, parsing the text of discussions of ESG risks in these documents can yield a gold mine of useful information for privately-owned companies trying to understand their respective ESG risks. These companies - regardless of shape and size - would be well-served by undertaking such an exercise.

managed more easily if they are identified and addressed years in advance, rather than on the eve of a key milestone.

Another way to mitigate the risk of such failure is to consider the establishment of incremental ESG goals. Opportunities for more incremental ESG goals may exist in areas where well-established track records and competencies already exist, such as occupational safety or product lifecycle management.

Where Else to Go?

Critical Audit Matters

An emerging source of ESG information in a 10-K is the outside auditor's communication of so-called "critical audit matters," or "CAMs" for short. CAMs relate to accounts or disclosures that are material to the financial statements, and involve *especially challenging, subjective, or complex auditor judgment*. A similar requirement exists in the U.K. for "key audit matters."

At least one global energy company based in the U.K. has identified the potential impact of climate change and energy transition as a key audit matter. A significant portion of the discussion of this matter focused on how a transition to cleaner forms of energy may impact the value of long-term tangible and intangible assets.

CAMs are relatively new, so it may take several years for a pattern and practice of identifying and describing ESG-related CAMs in 10-Ks to emerge. When this happens though, these ESG-related CAMs are likely to provide very useful insights on how outside auditors and management view the impact of climate change

MD&A, Legal Matters & Contingencies

The discussion of financial condition, market risks, and operating results in Items 7 & 8 of a reporting company's 10-K can be a rich source of information regarding a company's views on the business opportunities and risks associated with ESG initiatives. Management's Discussion and Analysis of Financial Conditions and Results of Operations - more commonly known as the *MD&A* and found in Item 7 of a 10-K - can be particularly useful for gaining a more granular understanding of the reporting company's ESG strategic objectives, and its plans for achieving such strategic objectives. As the SEC notes in its investor bulletin entitled *How to Read a 10-K*, this section allows the company to tell its story in its own words.

Item 8, entitled *Financial Statements and Supplementary Data* is where the reporting company presents its audited financial statements. These statements are accompanied by explanatory notes that cover a wide variety of topics, including legal matters and contingencies. For someone unaccustomed to reading a 10-K, these notes can be difficult to find, but they can convey important information on a company's ESG strategic objectives and performance.

and other ESG-related issues on the company's operations, assets, and financial condition.

Often times, there will be a significant amount of overlap or repetition between the information conveyed in the MD&A and the information contained in the explanatory notes to Item 8. However, this is not always the case. That is why it is typically useful to review Items 7 & 8 together.

Wrapping It All Up

There is a plethora of information these days about the various ESG-related initiatives being undertaken by organizations of all shapes and sizes. What makes the 10-K stand out as a particularly valuable source of such information is the uniformity of content and design. Publicly traded companies are required to present particular information in a certain way, so that an investor can understand the company's financial condition, results of operations, and business risks. This uniformity of substance and form makes it easier for investors to digest these issues. Such uniformity also makes it easier to identify trends and patterns across particular types of companies, or even entire industries.

Environmental professionals who have been charged with evaluating, developing, or implementing climate and other ESG initiatives for their own respective organizations - whether public or private - would do well to review the 10-Ks of similarly situated organizations. For those who are not quite as familiar with these reports, it may take reading a few of them to obtain a sense for where to find and understand the climate and ESG-related disclosures of interest. In addition, as was noted above, the SEC has a particularly valuable resource on how to read a 10-K. (Click here for a link to this document.)

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