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Directors and ESG Reporting:

Getting Better Answers

Protiviti recently published "10 ESG Reporting Questions Directors Should Consider.[1]" It's a good list. Will Directors know what to do with the answers? Or if the answers make sense? Directors could use more background on the underlying ESG risks and opportunities to help steer companies towards optimal success. As an ESG specialist/ Sustainability specialist, Douglas Hileman Consulting LLC (DHC) offers five tips to get more out of these conversations. [See blog posts for CAEs and EHS Audit Program Leaders.]

1. **Develop preliminary expectations for the answers.** Protiviti suggests Board members ask "What story are we telling the street?" Some content should be included in Management Discussion & Analysis of the 10-K, if the company is following SASB disclosures. Is it easy enough to find? Does it make sense? There are several ratings entities that compare ESG performance of companies based on "the stories told to the street"; how does your company compare? (Note: that the ratings entities' methods vary and may not be transparent.) Leverage some advance research to draft some insightful, probing questions.

2. **Know where this information should be coming from**. ESG topics pervade the entire organization. Topics in Protiviti's questions include incentive compensation plans, risk assessments, external reporting, COVID-19/ health and safety, and climate change. Responsibilities for these areas are typically dispersed – in HR, Operations, Environmental, Supply Chain Management, Quality, Health & Safety and other areas. If all the answers come from the CFO or Marketing, dig deeper.

3. **How <u>should</u> Management be identifying and managing ESG risks?** Protiviti suggests Directors ask about the risks and company's management and cites guidance from COSO. Climate change is arguably the single biggest and most prevalent ESG risk today. The Task Force on Climate Change Related Financial Disclosures (TCFD) provides a roadmap of identification and expected disclosures. TCFD focuses on investor interests, and financial value. If the company is not following these, management could be taking unnecessary financial risk. ESG poses inherent challenges, including the number and diversity of topics, inclusion of supply chain and other stakeholders in ESG risk/ Sustainability risk. Consider how this disparity could pose enterprise risk, and how it could be mitigated.

[1] "10 ESG Reporting Questions Directors Should Consider", published October 2020; accessed several times through January 18, 2021; available at [10 ESG Reporting Questions Directors Should Consider | Protiviti - United States].

4. **Insist on complete, reliable, supportable data and information.** The non-financial reporting frameworks and standards signal how ESG stakeholders will evaluate the company. Many non-financial reporting parameters do not arise through government regulations, but through standard-setting processes. Consider how companies typically approach compliance requirements for new laws (involvement of Legal, then Management, Operations, IT, etc.). Company Management may be positive on reliability of ESG disclosures, perhaps even including an ESG audit. ESG Audits (aka "Sustainability audits") can be helpful, but even assurance engagements only go so far. Many second line audit programs (environmental audit, etc.) remain focused on regulatory compliance, and do not yet consider these risks. Contrast this with the rigor used for internal controls over financial reporting (ICFR) and the extent of Internal Audit and external (financial) audit attention since Sarbanes-Oxley was passed in 2002.

5. **Provide direction for a dynamic future.** Management will probably acknowledge some ESG risk that requires short-term attention. ESG covers a lot of ground – and it is changing fast. Just in 2020, there have been dramatic changes involving: non-financial reporting frameworks and commitments; expectations on diversity, inclusion, and racial justice; climate change; and new requirements via regulatory, contractual, commercial, and social mechanisms. Many of these changes in external drivers will require the company to make substantive changes to keep pace in the medium, and long-term. These will be essential to maintain financial performance, to create financial value, and to improve the environment and human capital. How will the company meet these challenges? How will they identify when mid-course corrections are required, and do they have the authority and expertise to make them? Directors should listen for answers that align with short- medium- and long-term, and include monitoring and flexibility for periodic adjustments.

About Douglas Hileman Consulting LLC

Douglas Hileman Consulting LLC (DHC) supports Clients in environmental, social and governance (ESG, or "Sustainability"), audits/ risk/ compliance, and non-financial reporting (aka "Sustainability reporting"). Mr. Hileman has been in the forefront of emerging issues for over forty years. He has worked in operations and corporate compliance; environmental, health and safety compliance and auditing; Internal Audit; and external assurance for financial audits and conflict minerals submittals to the SEC. He was the senior technical specialist in environmental management and environmental auditing on the Volkswagen Monitor team, created for the company to fulfill obligations to the US Department of Justice. Mr. Hileman has reviewed frameworks for non-financial reporting (SASB, GRI, etc.), submitting comments on many proposed revisions. He helps members of the Institute of Internal Auditors stay abreast of changing risks and opportunities. As an ESG specialist/ Sustainability specialist, he has supported Client audits, conducted audits, and redesigned Client EHS/ ESG audit programs (often after an EHS audit program Quality Assurance Review (QAR)).

Prior to launching his firm in 2008, Mr. Hileman worked at a Big 4 accounting firm for six years, supporting financial audits, enterprise risk management, internal audit and the Sustainable Business Solutions practice. Mr. Hileman holds the credential in Fundamentals in Sustainability Accounting (administered by the Sustainability Accounting Standards Board). He is also a Certified Risk Management Assurance (CRMA) professional, and a Certified Professional EHS Auditor (both granted by The Institute of Internal Auditors).

See also www.douglashileman.com.