# ESG, Internal Audit, and Sustainability Reporting: In Six Polling Questions

By Douglas Hileman, CRMA, CPEA, FSA

I presented on ESG and Non-Financial Reporting (aka Sustainability Reporting and Disclosures) in two sessions at the IIA Los Angeles conference in March 2021. Internal Auditors' response to polling questions provides a glimpse of the state of ESG risk, Internal Audit's current role, and the journey that lies ahead. This white paper includes the questions, responses, as well as commentary and tips.

Virtual conferences are challenging for fatigued attendees, and presenters too! Presenters can't interact with attendees, watch body language, expand upon topics of particular interest, or move on at signs of boredom. Presenters can't ask for a show of hands, but polling questions help.

I developed polling questions with several objectives:

- Be more responsive to attendees;
- Gather information on the current state of Internal Audit, ESG, and Sustainability reporting and disclosures; and
- Offer a broader audience to answer the same questions to see how they stack up.

What is your organization's commitment to Sustainability / ESG, and transparency?

Which ESG topic is most material to your organization?

Where does ESG "live" in your organization?

What source of ESG information would you find most useful when making a conscious investment?

How many internal audits of ESG topics has your organization done in the last 5 years?

What is Internal Audit's role in Non-Financial Reporting (NFR) at your organization?

See www.douglashileman.com
And special purpose sites:
www.auditreadinesspro.com
www.environmentalfraud.com

So go ahead – take your own poll. Poll your peers, your Internal Audit function, second line audit functions (environmental audit, health & safety audit, HR audit, etc.). It could spur more effort on ESG risks and opportunities. Even if you do well, don't get comfortable – ESG is moving fast!

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## 1. What is your organization's commitment to Sustainability / ESG, and transparency?


- The top response – at 28% - was complete commitment and transparency.
- Complete commitment with good transparency; and good/ medium, tied for second at 16% each.
- 13% indicated the commitment was good, but transparency was provided only when required.
- 9% said ESG commitment was lip service.
- Nearly one-fifth (the second most popular option) indicated little or no commitment at all.

It is heartening that the top response was for complete commitment and transparency. Even with the bar reduced to "good" on commitment and transparency, the collective responses were only 60%.

The collective responses to the lowest three options of commitment and transparency garnered 40% of the vote. With 19% indicated little or no commitment, lip service (another 9%) is essentially the same thing,

Respondents indicating good commitment, and transparency only when required, made up only 13% of the vote. This option indicates these organizations do not fully grasp ESG as a business imperative. Organizations that provide transparency "only when required" are missing the point of ESG risk and opportunity. These organizations are destined to fall behind.

**Tips:** Internal Audit has a role to play for all these responses. For the lower three categories of commitment, Internal Audit should characterize ESG risks and opportunities to the organization. They should raise the topic with the Board if Management is not supportive. Internal Auditors at organizations with high levels of commitment and transparency should not rest easy.

Commitment is one thing; making good on it via transparency is quite another. Greenwash is easily discovered – including by your own employees. Social media can accelerate and amplify impacts. Internal Audit must hold Management accountable for this, monitor programs and risks on an ongoing basis, and have candid discussions with the Board.

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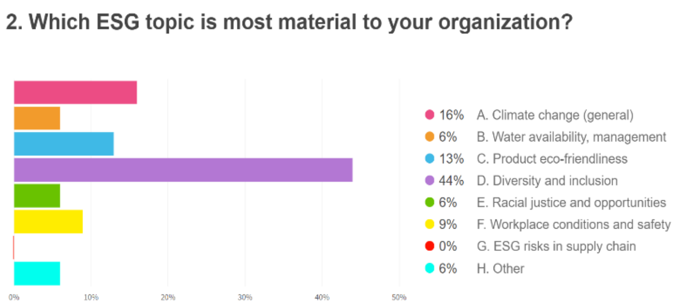
## 2. Which ESG topic is most material to your organization?




- Diversity and Inclusion was the runaway favorite, at 44% of respondents. Racial justice had 6% response, with these two topics collectively at exactly half the vote.
- Climate change was a distant second at 16%; with product eco-friendliness and water availability adding to a total of 35% response for environmental topics.
- Even after a year of COVID-19, workplace conditions and safety garnered a mere 9% of the vote.
- ESG risks in supply chain did not attract a single vote.

Many Fortune 500 companies have created new positions for Diversity and Inclusion officers in the last year, so the issue is visible. COFID-19 has wreaked havoc in the last year as well – and it's not over. COVID exposed the risk of occupational health and safety throughout the entire life cycle of a product or service, from supply chain to product use and disposal. Climate Change is the single most pervasive and prominent issue in non-financial reporting frameworks; it poses some type of risk to operations or financial performance to every organization.

The array of material ESG topics identified by Sustainability Accounting Standards Board (SASB) suggest a slightly different picture. Each industry sector has ~8 – 12 "material" ESG issues, applying the definition from the U.S. Supreme Court for prospective investors. Perhaps no single topic should get more than 15 to 20% of the vote.

**Tip:** Focusing on high visibility issues shows concern and responsiveness, and can generate some "quick wins." Internal Audit should not lose sight of the bigger picture, including established standards and techniques for identifying material ESG topics for priority attention.

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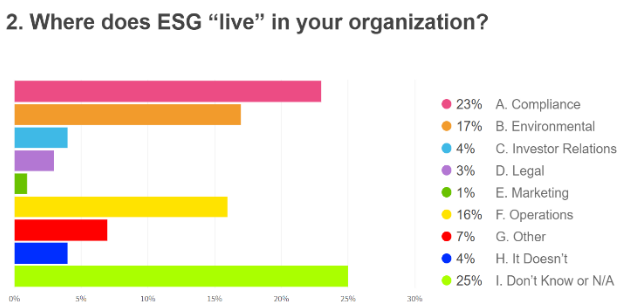
## 3. Where does ESG "live" in your organization?




- The biggest response – at 25% - was "don't know or N/A".
- Compliance got ~30% of those who responded.
- Environmental was second with ~23% of those who responded, barely edging out Operations (~21%).
- Investor Relations, Legal and Marketing each notched vote, with ~9% of those said "Other".
- ~5% of those answering acknowledged "it doesn't".

These answers indicate the wide variability in approaches to managing ESG issues. ESG has become formidably complex. There are hundreds of ESG topics. There are scores of statutory and regulatory compliance obligations, legal requirements in customer contracts, obligations with the supply chain, and expectations from a range of stakeholders. Most of these functions are designed to handle some of these topics well. For others, not so much – let alone being provided the resources and authority to do so.

"N/A" could denote a student or retiree; however, all respondents answered another question about the most material ESG topic to their organization. This likely reflects the low profile of ESG in their organizations.

This distribution of ESG ownership poses its own risk. These groups have different capabilities for ensuring the reliability of data and information. Furthermore, each group likely has different capabilities for different topics. Environmental, for example, may have robust systems, tools, processes and controls for data and information for regulatory compliance. Environmental may have far less developed systems and tools for environmental requirements that originate with customers, industry standards, or company commitments. Environmental has even less visibility and competence for other ESG topics. Environmental can develop, acquire, or engage external resources with competencies in these areas, but it is simply not part of traditional Environmental experience and training.

**Tip:** Internal Audit would do well to recognize the risk posed by highly distributed responsibilities for ESG topics, and the inherent limited ability of any one function to manage them all with sufficient degree of proficiency.

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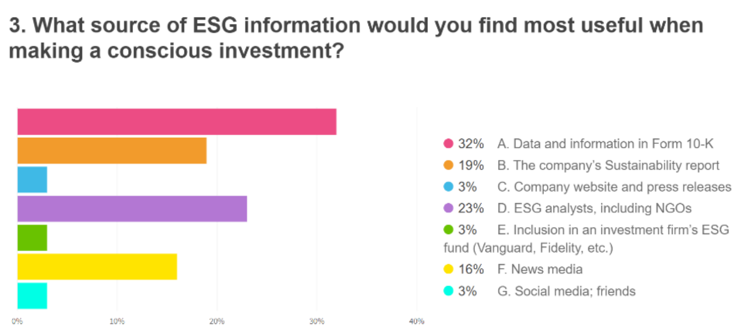
**4. What source of ESG information would you find most useful when making a conscious investment?**




- Data and information in a Form 10-K was the winner, with 34% selections.
- ESG analysts (including NGOs) picked up 23% of the responses, with the company's Sustainability report not far behind (19%).
- There was a three-way tie for last: company website and press releases; inclusion in an investment firm ESG fund; and social media/ friends.

It is reassuring to see the Form 10-K as the most trusted source. With Internal Audit's role in assurance of Internal Controls over Financial Reporting, it is surprising to see this capturing only one-third of the vote. Respondents place nearly as much trust in analysts and NGOs, suggesting they don't trust information in the 10-K to present the full picture.

It was heartening to see social media / friends in last place – so much for those Varsity Blues influencers! It also speaks volumes that company websites are regarded as just as trustworthy. Investment firms lean on analysts for interpretation of ESG performance and risk – yet including in an ESG fund got only 3% response, whereas the analysts themselves got 23%!

**Tip:** The responses confirm that even sophisticated, evidence-oriented people (internal Auditors!) seek a variety of sources for ESG data and information. This highlights the importance of data being complete, accurate and verifiable as your organization reports it though all these channels.

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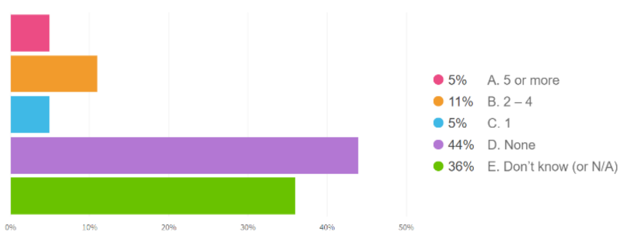
## 5. How many internal audits of ESG topics has your organization done in the last 5 years?

**3. How many internal audits of ESG topics has your organization done in the last 5 years*? (*Between 2015-2020, and also include if an ESG Audit is in your 2021 Audit Plan)**




- 44% said none. Another 36% didn't know.
- 5% had done one, and 11% had done 2 – 4.
- 5% had done 5 or more – one every year. .

The presentation had laid the groundwork for what constitutes the "E" and "S" pieces of ESG: environmental; climate change; plastics; water scarcity and quality; extreme weather events (including their effects on operations, supply chains, and revenues); ecosystems; "forever chemicals" and bioaccumulation; occupational health and safety; racial justice; diversity and inclusion, etc. The presentation also covered how these risks extended beyond the traditional four walls of any enterprise – including into the supply chain; down the value chain; and as affecting stakeholders/ interested parties. By the time of this question, there was little chance the attendees would "forget" about an audit of ESG because they were not aware of what it includes. Internal Audits are not being done.

For another polling question, 20% responded that ESG is in their Risk Assessment or Audit Plan every year. That matches the number of respondents who had done at least one audit in the last five years.
These two responses are further suggestion that Internal Audit does not yet fully appreciate the breadth of ESG issues or their risk. Perhaps the conversations with Management or the Board are not sufficiently meaningful.

Investor interest is increasing with breathtaking scope and speed. Investors insist upon meaningful, supportable reporting and disclosures on ESG issues that are material for companies' sectors, so they can be compared with peer companies to make informed investment decisions.

**Tip:** ESG should be in the Risk Assessment every year. Any engagement – including an advisory engagement – will help Internal Audit keep their finger on the pulse of ESG, as well as opportunities for the organization to excel. With apologies to Humphrey Bogart as Rick Blaine in Casablanca, "of all the topics in all the frameworks in all of ESG … <u>one</u> of them should walk into my Internal Audit gin joint!"

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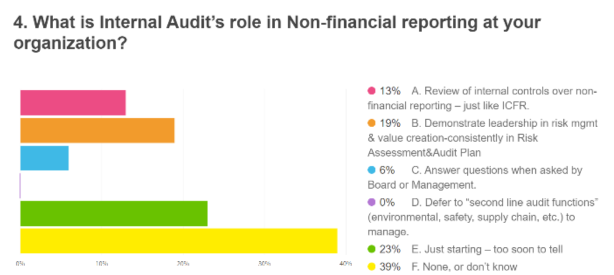
## 6. What is Internal Audit's role in Non-Financial Reporting (NFR) at your organization?




- The top response – at 39% - was "None or don't know."
- ~38% of those who answered (23% total) indicated they were just starting.
- 10% of those responding are in reactive mode, answering questions only when asked.
- 30% of those responding are demonstrating some leadership
- ~20% reviewing internal controls over non-financial reporting, just like they review Internal Controls over Financial Reporting (ICFR).

13% chose the most mature option – reviewing internal controls, just like Internal Audit does for Internal Controls over Financial Reporting (ICFR). ESG reporting is a more recent phenomenon, but many of the same skills apply. One in five indicated they demonstrate leadership in risk management, and that ESG is consistently in the Risk Assessment and Audit Plan. [See another question for how many of these Audit Plans resulted in audits.]

The runaway winners were "none/ don't know" or "just starting", with a combined score of over 60%. Exactly zero respondents indicated they defer to second line of defense auditing functions (environmental, supply chain, etc.) to manage the issue.

It may be that the 39% who do not know Internal Audit's role work in organizations where ESG is a low priority. This – and the 23% in start-up mode – indicate how far Internal Audit must go.

**Tips:** There is still room to grow beyond the most mature option offered in this poll. ESG issues evolve from awareness to business imperative (including reporting and disclosures) in non-traditional ways – and fast. Internal Audit should also be monitoring these emerging issues.

Second Line of Defense (2LOD) audit functions can also play a role. Internal Audit assumed roles for ICFR to support the external auditor, and for more efficient, effective, and lower-cost effort. Audit programs for Environmental, Health & Safety, Quality, HR, IT, and others exist at many companies. The charter and objectives of many of these 2LOD programs have not been revised for years, nor have they undergone a Quality Assurance Review (per IIA Standards). Redesigned environmental audit, safety audit, and other 2LOD audit programs can leverage Internal Audit's roles and responsibilities, in line with the IIA's three lines (of defense/ governance) model.

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