ESG Symposium
Insights on Internal Audit and Risk Management From Six Polling Questions

By Douglas Hileman, CRMA, CPEA, FSA

The Institute of Internal Auditors (IIA) offered an ESG Symposium in April 2021. This virtual event – the first of its kind – was favorably received by over 300 IIA members.

Polling questions provided the opportunity for "instant benchmarking" about ESG drivers and risk, environmental risks, and Internal Audit's leverage of second line audit activities. This paper provides responses to six questions of keen interest to Internal Audit today, and perspectives on what these responses mean for ESG and Internal Audit.

- What is the primary driver for Board interest in ESG?
- What government action will have the biggest effect?
- Where does ESG live at your company?
- What ESG reporting framework(s) do you use?
- What is ESG's current role?
- What SHOULD Internal Audit's role be in ESG reporting?

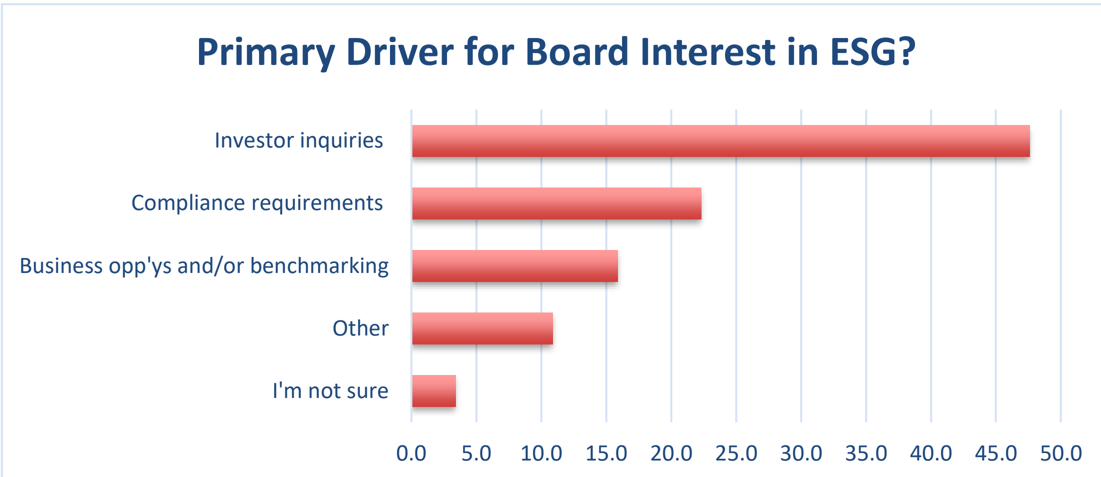
There were more questions – on environmental and social issues, and the symposium's demographics. For the complete paper, contact info@douglashileman.com.

There was universal agreement on one issue:

Exactly zero respondents indicated that the Board's interest in ESG would decline in the next three years. Zero.

Respondents indicated the Board's interest would increase broadly, or on material topics, or as a result of an issue or incident specific to the organization.

What do you believe is the primary driver for Board interest in ESG?



- Investor inquiries was the runaway favorite, at 47.6%.
- Compliance requirements was next, at 22.3%.
- 15.9% said business opportunities or benchmarking.
- Only 3.4% weren't sure.
- "Other" included: executive priorities; COVID-19 issues; or business opportunities.

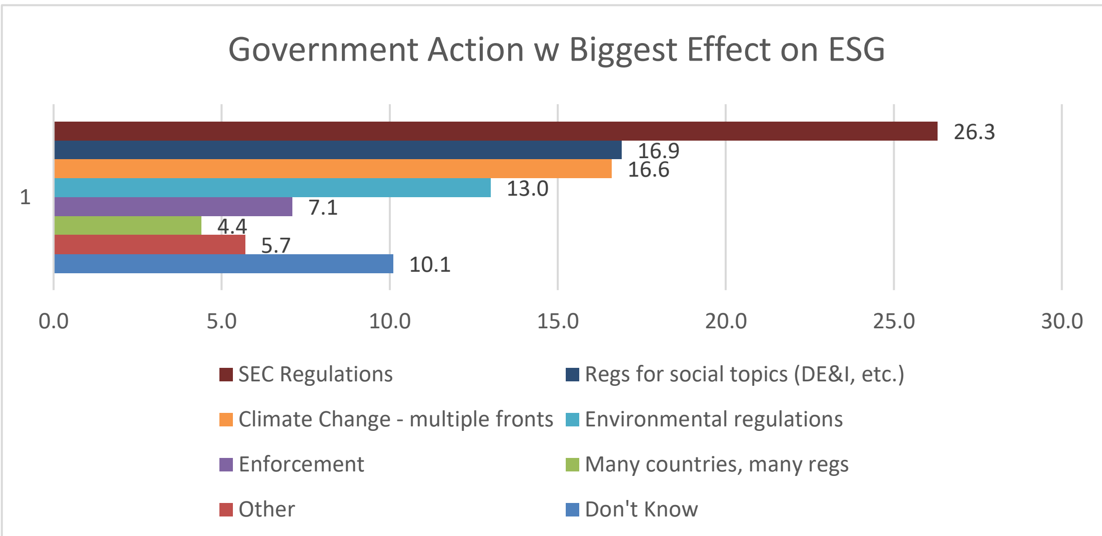
Perspectives: SEC's invitation for public comment on climate change disclosures was released a month before the Symposium. SEC had also mentioned ESG in enforcement priorities.

The Symposium came a few weeks after World Economic Forum, where the Big 4 and world economic leaders endorsed sustainability reporting and disclosures. Larry Fink's (Blackrock) 2021 letter to investors reinforced commitment in 2020 to meaningful ESG performance and disclosures. [Mr. Fink's January 2022 letter continued the tradition.]

These poll results were prior to the formation of the International Sustainability Standards Accounting Board and developments in the EU.

Poll answers don't tell the whole story. For example, has Internal Audit actually heard this from their Boards? Internal Audit should understand each of these drivers and actively engage with Boards and management on all of them.

What government actions will produce the biggest effect on ESG?



- SEC regulations and initiatives was the winner, at 26.3%.
- Regulations for social topics (16.9%) and climate change (16.6%) followed – nearly a tie.
- Only 7.1% felt that enforcement would be the primary driver.
- Only 4.4% picked “many countries, many regs.”
- Even with six other great options, one in 10 didn’t know.

Perspectives: The SEC welcomed public comment in 2021. Commissioners signaled the SEC would propose guidance by the end of 2021 – but didn’t. Global developments (notably establishment of the ISSB) occurred much faster than anyone expected. SEC may have just paused to align guidance with a global approach on a global issue.

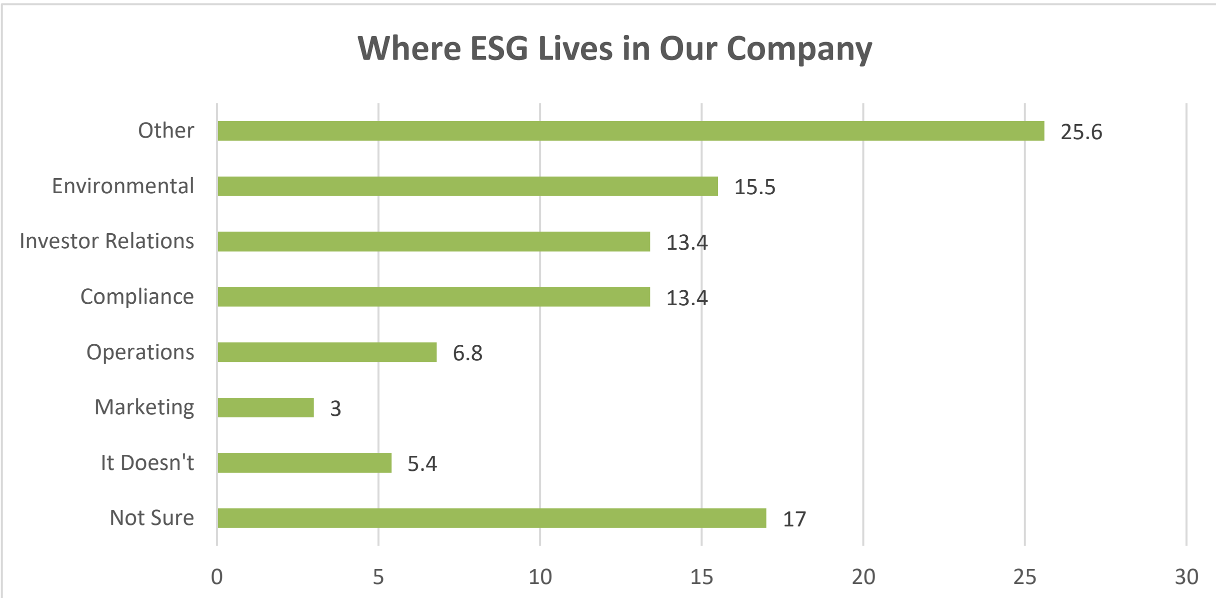
“Social topics” covers privacy, labor rights, modern slavery, diversity, and many others. Even with climate change prominent in the news, respondents felt social topics would be as important.

The EU’s Non-Financial Reporting directive is familiar – and being replaced by a Corporate Sustainability Reporting Directive. South Africa, Australia, and Singapore are among countries with their own ESG rules. State and local jurisdictions are also busy. Global companies know this now.

Governments have a substantial effect on ESG via its procurement. Governments require ESG programs, performance and representations as a condition of contracting – and this is growing.

New ESG laws, regulations and government requirements could be outpacing the ability of Compliance departments to address them.

Where does ESG "live" at your company?



- There was nearly a three-way tie for the most popular option: Environmental (15.5%), Compliance, and Investor Relations (13.4% each).
- "Other" was the most popular response, at 25.6%. This could be CEO, Finance, Human Relations, Legal Safety – or others.
- Just over 5% of respondents were brave enough to admit that ESG doesn't live anywhere in their organizations.
- Marketing had the lowest response of the specific options provided – at 3%.

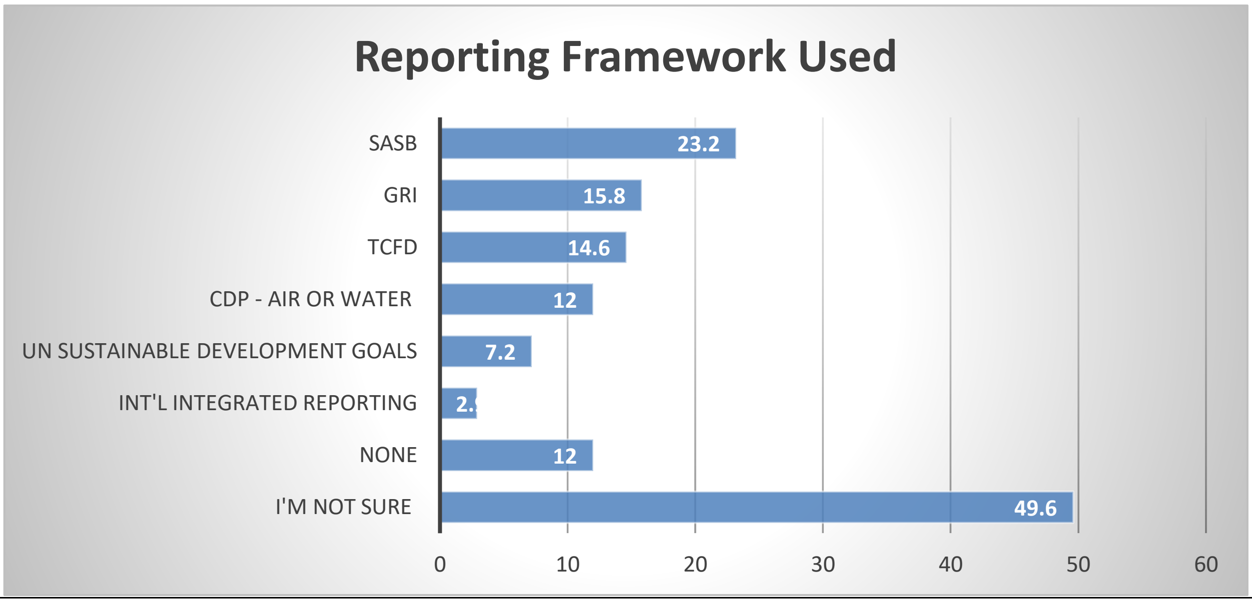
Perspectives: There is no consistent "home" for ESG.

The Legal department could be a leader among the "Other" options, given the extent of new and emerging compliance obligations.HR often leads diversity and labor issues. There are standalone Safety departments at many companies. Real Estate could manage utilities.

These departments have different approaches to internal controls, which may be designed for regulatory compliance (for example, to EPA, OSHA or Department of Labor). This will pose significant challenges as companies scramble to provide complete, accurate and verifiable data for disclosures to capital markets.

Governance is the "G" of "ESG." Internal Audit can add value simply by stressing the importance of good governance of ESG itself.

What ESG reporting framework does your organization use? (Indicate all that apply)



- Half – 49.8% - didn't know what (if any) ESG reporting framework(s) their organization uses.
- SASB was mentioned more than any other framework, by 23.2% of respondents. Another way, of those who did provide an answer, nearly half knew of SASB.
- GRI ranked next, with 15.8% of respondents, with TCFD was close behind, at 14.6%.
- One in eight respondents (12%) knew their organization uses no ESG reporting framework.

NOTE: This poll was taken before formation of Value Reporting Foundation, and before the creation of International Sustainability Standards Board.

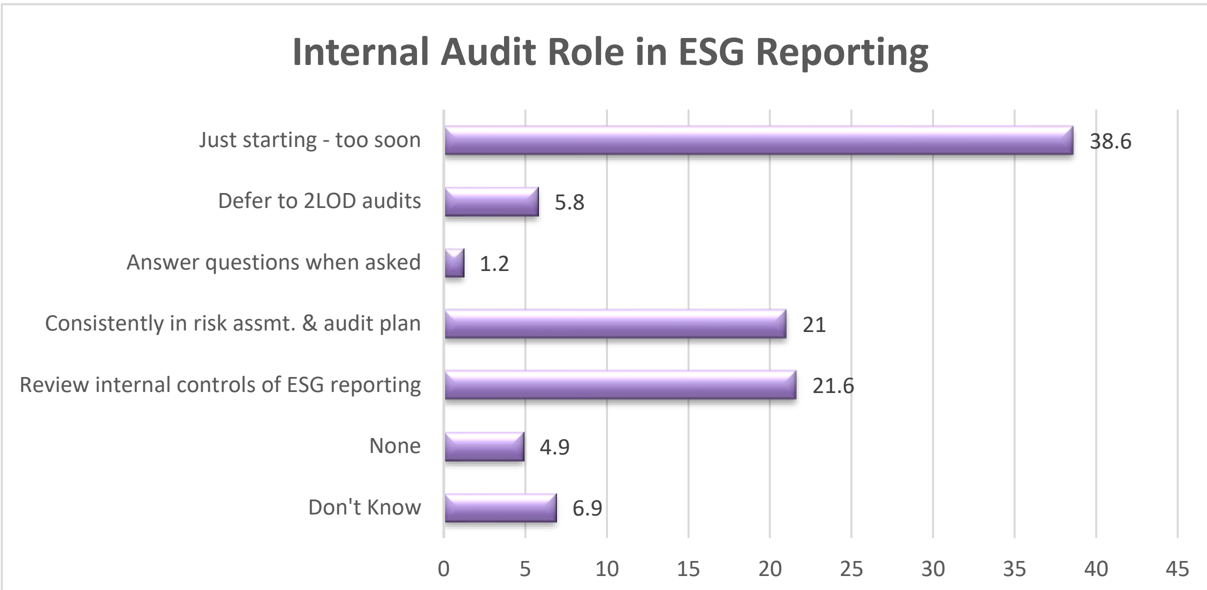
Perspectives: SASB has been around for only 10 years, founded with the mission of providing relevant, comparable ESG disclosures to investors. Of those who did provide an answer, nearly half cited SASB.

GRI has existed for twice as long; standalone Sustainability reports are familiar to nearly everyone interested in ESG. Yet only one third of those who mentioned a framework indicated GRI. This could reflect the fact that Board interest originates primarily with investor expectations.

Since this poll, the UK has codified that TCFD must be used for disclosures.

The fact that only half of the attendees could provide an answer may reflect the extent of Internal Audit's current involvement with ESG reporting. Internal audit should learn more about ESG reporting frameworks, and their intended audience(s). Internal Audit should prepare for the expectation of external assurance – Internal Audit should get there first!

What is Internal Audit's CURRENT role in ESG reporting?



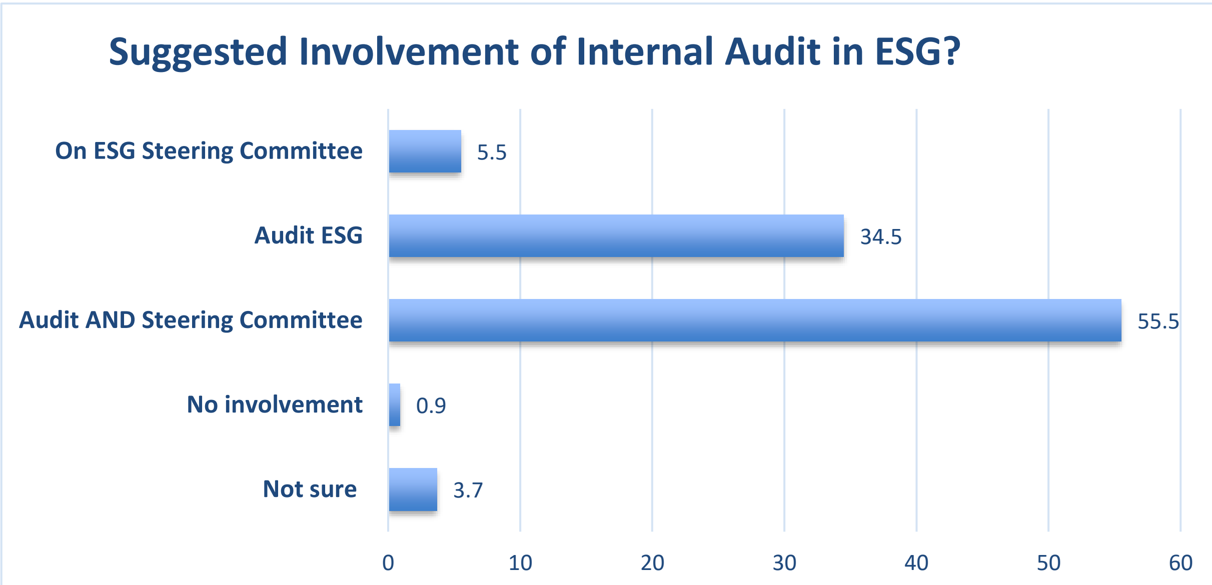
- The largest cohort – 38.6% - were just starting as of April 2021.
- Equal numbers – about one-fifth each – indicated that Internal Audit reviews internal controls of ESG reporting, or consistently include it in their risk assessments.
- Few (5.8%) deferred entirely to second line audit functions.
- Almost nobody (1.2%) is in strictly reactive mode, answering questions only when asked.

Perspectives: The options were structured to reflect a maturity model of Internal Audit involvement in ESG reporting.

21% indicated they review internal controls over ESG reporting. This is a large cohort, especially given that only about half knew which ESG reporting framework their organization used. Only 23% indicated they used SASB, with 17% using TCFD. These frameworks are intended for capital markets (and multiple responses were possible). Many Internal Audit departments have moved surprisingly quickly up the maturity model. This may overstate actual practice, given the author's outreach via other channels – and the request for those conducting assurance of internal controls of ESG reporting to contact the IIA.

Very few had zero involvement, remain in reactive mode, or defer to 2LOD audits. It is encouraging that Internal Audit is doing something. [Some attendees may be from academia, small consultancies, or retired – and therefore have no reason to be doing anything.]

What SHOULD be the involvement of Internal Audit in ESG reporting?



- For this question, note that "A and B" was an option. It got the most votes, at 55%.
- This means that a whopping 90% of respondents think IA should audit ESG.
- Over 60% felt IA should be on an ESG Steering Committee.
- Fewer than 1% thought Internal Audit should just stay out of it.

Perspectives: There have been dramatic developments in ESG reporting and disclosures since this polling question in April 2021. SASB merged with the IIRC into the Value Reporting Foundation. The VRF, in turn, was folded into the newly-formed International Sustainability Standards Board. GRI finalized new universal reporting standards, effective for 2022. The demand for external assurance is consistent in all these developments.

The systems and internal controls underlying ESG data and reporting are far less mature than for financial reporting. Whereas less than a year ago, Internal Audit may have regarded an "audit" (one?) as a good step, this falls far short in terms of preparing for external assurance. Internal Audit leaders are catching on. Internal Audit leaders and their stakeholders will soon learn the extent of the journey that lies ahead.

ABOUT DOUGLAS HILEMAN CONSULTING LLC

Douglas Hileman Consulting LLC (DHC) helps clients meet challenges posed by ESG. Environmental, Social and Governance (ESG, often discussed as Sustainability) encompasses dozens of issues. Climate change, new regulations, modern day slavery, water quality and availability, growing stakeholder expectations, disclosures in financial filings – these are just a few. ESG issues have led to a growing body of compliance requirements, operational and reputational risks, and non-financial reporting (NFR) requirements. Some is mandatory, some is "voluntary". Companies are overwhelmed with the pace of change, and the expectations of different stakeholders. Structures and programs designed just a decade ago to meet ESG compliance requirements are still necessary, but they are no longer sufficient.

Our clients appreciate the breadth of experience in different lines of governance, industry sectors, and types of engagements. We collaborate with other firms, co-source with client teams, and perform independent engagements. It could be an evaluation of ESG internal controls; ESG risk assessment; specialist support to an ESG Internal Audit. Or a Quality Assurance Review of a (second line) EHS audit program, a co-sourced program re-design, training on environmental fraud or other emerging issues, preparing for a high-profile investigation or audit, or participating in a monitorship. Whatever the situation, we tailor our efforts to meet Client needs, and to create effective and efficient solutions. Our clients and colleagues appreciate DHC's 40+ years of relevant experience, and how it helps our clients manage ESG issues "at the speed of risk."

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