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ESG

Internal Audit’s Role in ESG

IIA Calgary Chapter—December 7th, 2022

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Territorial land acknowledgement

We acknowledge that our offices reside on traditional, treaty and unceded territories as part of Turtle Island (North America), which are still home to many First Nations, Métis, and Inuit peoples.

Introductions

ESG overview

Environmental, Social, and Governance (ESG) overview

Why ESG?

Regulators worldwide have continued to focus on climate change, executive pay, diversity and inclusion, working conditions, and product content issues (such as conflict minerals and child labor).

Many jurisdictions have mandated or encouraged greater disclosure of sustainability practices and risks, with major stock exchanges doing the same in various geographies.

Investors are requiring companies to understand and quantify their climate change risk, as well to contribute positively to society.

Pressure from consumers—and the associated risks to brand and reputation- should also be considered.

The information made available through sustainability reporting allows internal and external stakeholders to form opinions and make informed decisions about an organization's contribution to the goal of sustainable development.

ESG risks:

- As companies around the world now see ESG as an imperative, it becomes a key concern for all stakeholders, from current and prospective employees, shareholders, investors, and regulators to the larger community and society, to properly understand the risks associated with ESG.
- By becoming aware of the risks associated with ESG, companies can prepare the appropriate measures/responses to ensure their regulatory compliance and operational performance is maintained/enhanced

Below are some of the relevant risks associated with ESG:

- Extreme weather events
- Increasing regulatory requirements
- Shareholder Activism
- Intensified media coverage
- Heightened reputational exposure
- Diversity, Equity, and Inclusion

Additional issues linked to ESG which companies must be aware of:

- Climate Change
- Executive Compensation
- Tax Policy & Payment
- Health & Safety
- Diversity & Inclusion
- Resource Consumption & Efficiency
- Ethical Procurement
- Responsible Investment

ESG by the numbers

Stakeholder expectations are changing…

Investors

82% of investors agree that **ESG integration** will lead to outperformance in equities over the next 3 years[1]

Customers

7 in 10 people globally support organizing **consumer boycotts** against irresponsible companies[2]

Employees

86% of employees expect their CEOs to **publicly speak out** on important social issues[3]

Suppliers

1,000+ companies have set **science-based targets** to reach Net-Zero emissions[4]

Policymakers & Regulators

CSA, SEC, European Commission (EC) are all pushing for the expansion of **new policies** and **disclosure requirements**[5]

…and companies are responding…

200+

Roundtable's statement on a corporation's responsibility to all stakeholders

$35.3 *Trillion*

Global **sustainable investment** now tops $35.3 trillion—a **growth of 15% in two years**

92%

Of S&P 500 Index Companies published **sustainability reports** in 2020

Companies are advancing their Sustainable Development Goals (SDGs) through the **World Business Council for Sustainable Development**, the UN Global Compact, and the G7 Business **for Inaclusive Growth** coalition

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8. G&A Institute, Inc, "90% of S&P 500 Index Companies Publish Sustainability Reports in 2019, G&A Announces in its Latest Annual 2020 Flash Report", https://www.ga-institute.com/nc/storage/press-releases/article/92-of-sp-500r-companies-and-70-of-russell-1000r-companies-published-sustainability-reports-in-202.html, accessed January 24, 2022
9. World Business Council for Sustainable Development, "What's new", https://www.wbcsd.org/Overview/News-Insights, accessed September 3, 2021

Polling question 1

How strongly do you agree with the following statement: "Internal Audit will play an integral role in providing assurance to ESG compliance at my organization."

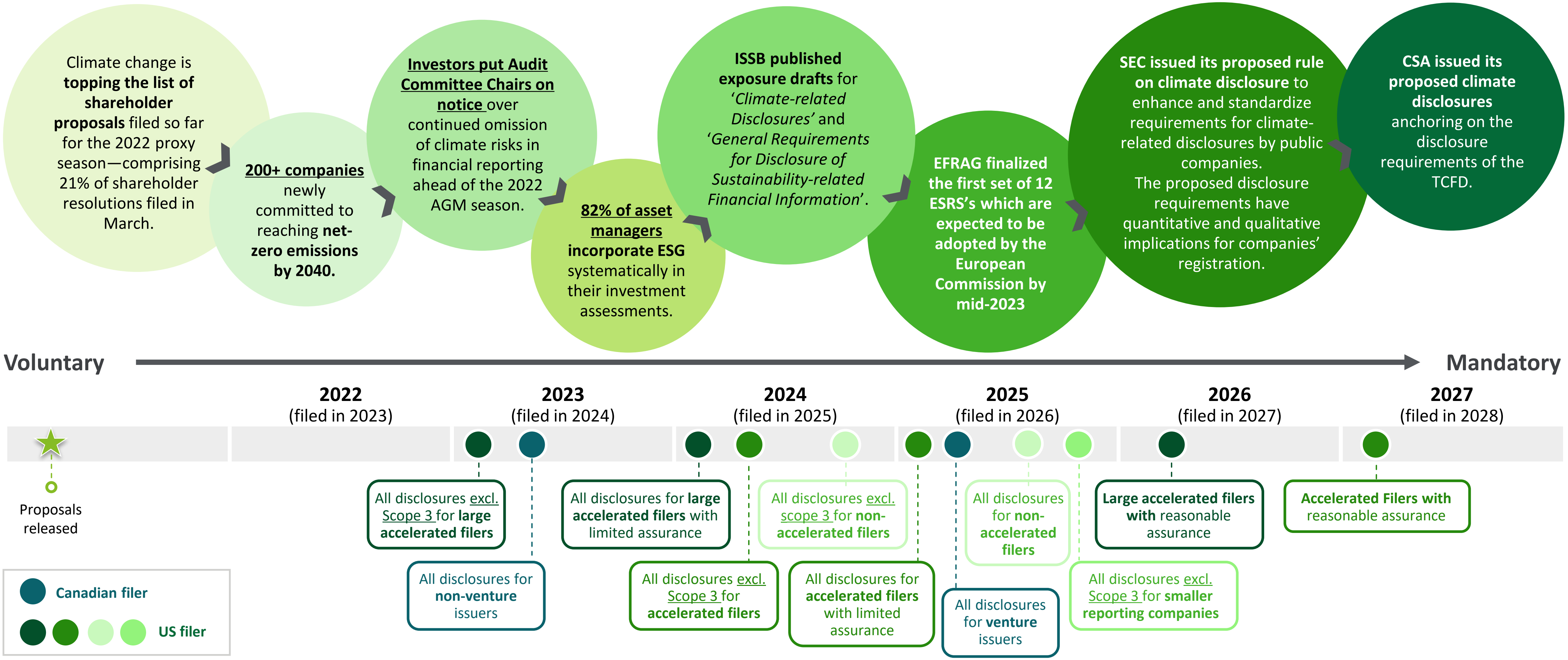
a) Strongly agree
b) Agree
c) Neither agree nor disagree
d) Disagree
e) Strongly disagree

ESG disclosure trends and developments

ESG reporting

The rapid pace of change: Shift from voluntary to authoritative ESG and climate disclosure

Global sustainable investment assets increased to $35.3 trillion, a growth of 15% in two years, and in total equating to 36% of all professionally managed assets across regions covered in the report. – GSIR Review 2020



Standard setting and regulatory requirements

The TCFD recommendations

The Task Force on Climate-Related Financial Disclosures (TCFD) has developed a framework to help companies integrate and disclose climate-related risks and opportunities.

Governance Structure

a) Describe the governance around climate-related risks and opportunities

b) Describe management's role in assessing and managing climate-related risks and opportunities

Strategy

a) Describe the climate-related risks and opportunities identified over the short, medium, and long terms.

b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.

c) Describe the resilience of the organization's strategy, considering different climate-related scenarios, including a 2°C or lower scenario.

Risk Management

a) Describe the processes for identifying and assessing climate-related risks.

b) Describe the processes for managing climate-related risks.

c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the overall risk management.

Metrics and Targets

a) Disclose the metrics used to assess climate-related risks and opportunities in line with its strategy and risk management process.

b) Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions and the related risks.

c) Describe the targets used to manage climate-related risks and opportunities and performance against targets.

The principles underlying these recommendations are largely applicable for achieving good environmental disclosures in general

Standard setting and regulatory requirements

ISSB Proposed Standards on Climate Disclosure

IFRS Foundation

ISSB **IASB**

In November 2021, the IFRS Foundation Trustees announced the establishment of the **International Sustainability Standards Board (ISSB)** to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs.

March 31, 2022

The ISSB launched a consultation on its two proposed sustainability standards:

1) IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*

- Requires an entity to disclose material information about all significant **sustainability-related risks and opportunities**.

2) IFRS S2 *Climate-related Disclosures*

- Requires an entity to disclose information about its exposure to significant **climate-related risks and opportunities**.
- This would be the ISSB's first **thematic** IFRS Sustainability Disclosure Standard, with the theme being climate.

Developments in ESG reporting: Regulatory—Canada

CSA Staff Notice—51-107, Disclosure of Climate-related Matters [Proposed]

The Canadian Securities Administrators announced Notice and Request for Comment—51-107, *Disclosure of Climate-related Matters,* which includes its proposed National Instrument and its companion Policy. The **comment period concluded on February 17, 2022. Review is ongoing.**

The proposed instrument aligns with the TCFD recommendations, subject to certain modifications.

Disclosure area

- Governance
- Risk Management
- Strategy
- Metrics and Targets

Largely aligned with TCFD

Where will the disclosures sit?

- The climate-related disclosure requirements relating to governance would be included in a reporting issuer's management information circular.
- For issuers that do not send a management information circular to its securityholders, the disclosure would be provided in the issuer's annual information form (AIF) or its annual management's discussion and analysis (MD&A), if the issuer does not file an AIF.

When will this happen?

- The Proposed Instrument contemplates a phased-in transition of the disclosure requirements, with distinctions for non-venture and venture issuers:

Category of issuer	Transition phase
Non-venture issuers	Financial years beginning on or after January 1 of the first year after the effective date of the Proposed Instrument (one-year transition phase)
Venture Issuers	Financial years beginning on or after January 1 of the third year after the effective date of the Proposed Instrument (three-year transition phase)

Source: CSA 51-107

Polling question 2

My organization's Internal Audit department performs a separate / standalone "ESG audit".

a) Yes
b) No
c) I do not know

Polling question 3

How strongly do you agree with the following statement: “My organization’s Internal Audit Department formally assesses ESG risks as part of the risk assessment process”.

a) Strongly agree

b) Agree

c) Neither agree nor disagree

d) Disagree

e) Strongly disagree

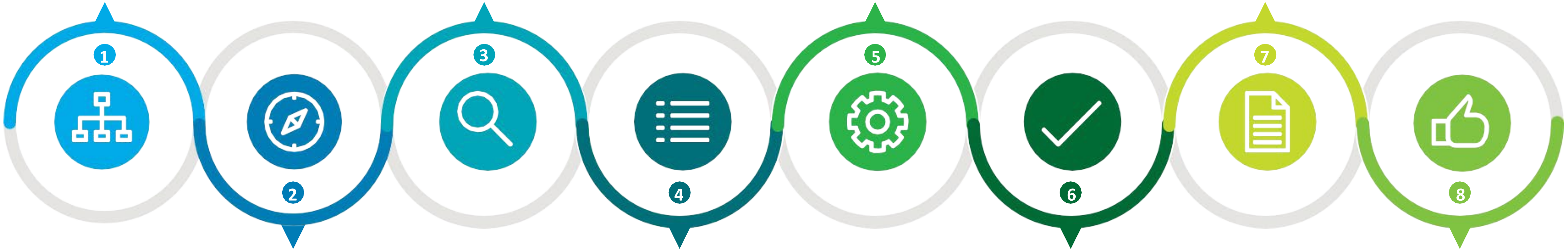
ESG considerations

ESG transformation

Organizations must transform their ESG program to ensure corporate and ESG strategy are closely aligned.

Align ESG and corporate strategy | **Transform operations** | **Disclose progress and improve**

1. **Understand needs and risks**
2. **Establish an ESG strategy as a part of the overall corporate strategy**
3. **Establish ESG corporate governance**
4. **Develop roadmap and clear ownership**
5. **Refine operations and processes**
6. **Measure and improve**
7. **Conduct internal audit and external assurance**
8. **Tell your story**



Internal Audit’s role in ESG reporting

Internal Audit’s role in assessing ESG reporting

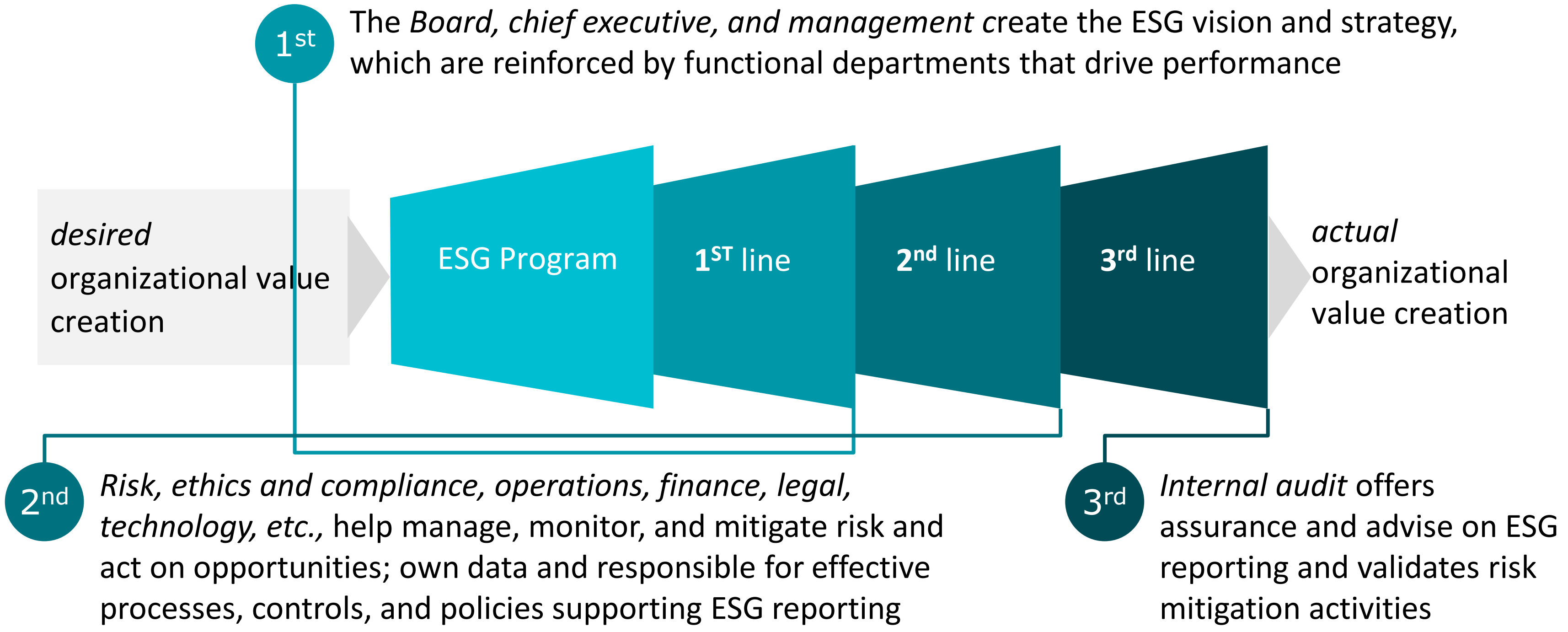
Integrate ESG risk and compliance considerations into the internal audit plan to instill discipline and enhance controls related to material ESG risks.

Example areas for action:

- Drive accountability and visibility while monitoring risks to the entity raised by environmental and social issues alongside ERM
- Enhance governance processes, controls, and policies in preparation for external assurance
- Leadership reporting to proactively identify risks, inform action plans, and promote ESG integration as a consultative resource to the ESG Committee
- Training and guidance to operational teams and business units

Three Line Model

Roles across the organization have a responsibility to manage ESG risk and drive organizational alignment.



Deploying a standardized end-to-end reporting process

Define and Organize → **Build and Implement** → **Operate and Report**

1. Prepare and launch

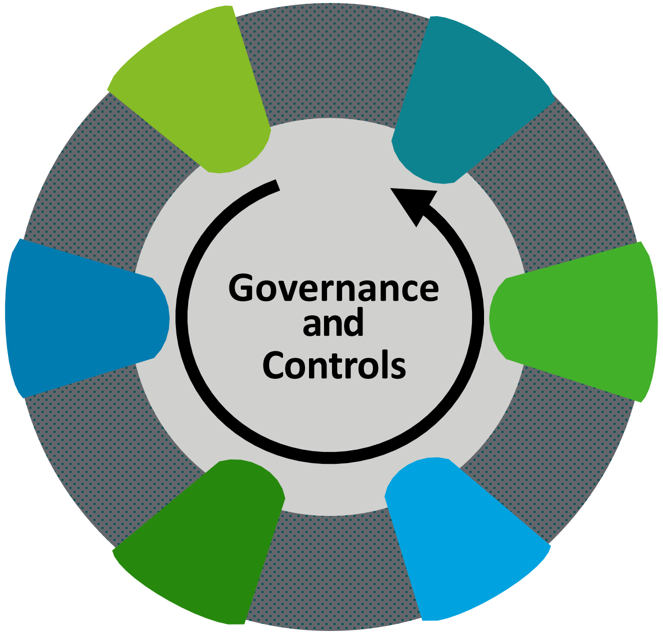
- Engage with stakeholders to assess ESG reporting commitments against current and emerging regulatory requirements
- Benchmark performance relative to industry peers
- Assess global trends and identify emerging risks
- Establish change management plan
- Develop a project plan and project management activities

2. Requirements and future state design

- Identify and capture ESG reporting process and data requirements
- Locate stakeholders and sources for ESG reporting data
- Determine tools and technology for future state
- Design an end-to-end future state process and roadmap for future state ESG reporting processes

3. Process development

- Establish framework, including roles and responsibilities, oversight structures, and reporting mechanisms.
- Build, configure, and setup enabling tools and technology
- Establish policies, processes, and internal controls



4. Process testing and refinement

- Refine and test the processes and controls required to deliver continuous improvement
- Execute maintenance and testing of enabling tools and technology

5. Change management

- Develop training materials and conduct training sessions
- Establish a production support model capable of accommodating an organization’s growth and changes within the ESG reporting landscape
- Develop and implement relevant ESG reporting KPIs and establish related monitoring dashboard(s)

6. Deploy

- Activate process, policies, and procedures
- ESG reporting governance and oversight structure
- Maintain enabling tools and technology supporting ESG reporting
- Integrate ESG reporting subject matter into the internal audit and compliance plan

The services described herein are illustrative in nature to demonstrate our experiences and capabilities in these areas.

Internal Audit approach's to supporting ESG reporting

A strong control environment as part of an effective governance structure is imperative as ESG considerations rise to the top of the agenda for stakeholders. With the increased attention on ESG comes an increased focus on data quality. Internal Audit plays a key role in bringing structure, rigor and internal controls around ESG risk.

Scope, assess and define

Identify and document data and controls

Perform testing

Execute remediation process

Monitor

Applying an IA approach to ESG reporting

Disclosure

- What disclosure exists?
- Who is responsible?
- Who is involved?
- What are the significant risks?

Frameworks and standards

- Are frameworks and standards used in current disclosure or internally (if so, which)?
- How can frameworks and standards enable internal audit's review?

Process and controls

- Are process and controls formal or informal?
- Are process and controls documented?
- How can lessons from other areas of internal controls (finance and accounting, risk management) be applied to ESG?

Leveraging the COSO Framework for ESG Reporting

Control environment → **Risk assessment** → **Control activities** → **Information and communication** → **Monitoring**

Data, processes and controls

ESG data is evolving from static and backward-looking to dynamic and forward-looking, harnessing the digital revolution. Companies are committing to improving their quality of ESG data management for better decision-making.

Data quality and maturity

Foundational

- Existing data usage (emails, production units, F&A, HR, HSE systems)
- Spreadsheets (and post-its)
- Manual data management
- High-level partner input (e.g. from reports)

Advanced

- Standard ESG reporting tools
- BI/Analytics dashboards
- Detailed supply chain reporting
- Sourced third party data
- Investing in ”for-purpose” solutions (often AI-powered)

Leading

- Boardroom using ESG data-driven insights
- Advanced ESG forecasting and predictions at the heart of strategic decision-making
- Exploration and investment in solution-building and data acquisition
- ESG data of sufficient quality to be tied to compensation and bonus schemes
- Ecosystem collaboration around new technologies, business models and partnerships

Data, processes and controls continued

Getting ESG data right requires a strong foundation and systemic approach across IT, processes and control.

Definition of metrics and data transparency

- Metric definitions, standard protocols and measurements
- Compliance with relevant external standards
- Alignment of assumptions, projections, measurements and the use of conversion factors in calculations
- Protocol for avoiding aggregations- and conversion errors (US ton vs. metric ton)

Scope of consolidation and reporting scope

- Consistent scope of consolidation and reporting period with key financial figures
- Specification of ‘consolidation groups’, e.g., ensuring alignment on which locations are relevant for collection of environmental indicators

Roles and responsibilities

- Clear allocation and definition of ownership and responsibilities as well as adequate competencies
- Formal procedures to ensure sufficient knowledge-sharing

Processes and IT

- Formal reporting processes
- Corporate reporting requirements and alignment of processes at each relevant location
- Definitions and descriptions of relevant data
- Use of IT-systems
- Clear and robust interfaces between manual and automated processes

Internal control systems

- Formal and operational control systems for non-financial key metrics
- Design—Controls are designed to address the risk of false statements
- Implementation—Ensuring that the controls are correctly implemented
- Operating Effectiveness—Ensuring that the controls are working optimally

Key considerations—ESG

The below risks can provide a starting point for Internal Audit functions to assess the risks across the enterprise.

	Key questions to ask
1. Governance and Policy	• Has the enterprise created a governance structure and culture that support effective climate risk management? • Has the organization defined strategy to strengthen internal awareness and commitment, emanating from top management (setting the "tone at the top")? • Is information on climate risk being reporting for the board?
2. Risk Strategy and Appetite	• Is climate strategy and risk appetite consistently cascaded through the organization, including limits and metrics? • Are climate-related risks being considered in new products and services? • How has climate change and the changing external business environment affects the resilience of the business model and hence the risk strategy?
3. Risk Assessment, Measurement and Analytics	• Has the organization defined a consistent and comprehensive methodology for climate quantification? • Has stress testing been adapted to reflect the long-term horizon of climate risk?
4. Monitoring and Reporting	• What climate-related disclosures around governance, strategy, risk management and KPI/KRIs are being published? • How is climate risk monitoring and reporting being aggregated into existing risk practices?
5. Portfolio and Capital Management	• Are there potential capital add-ons that are associated with integrating climate risk into existing risk management frameworks? • Are there portfolios of climate risk-related products and services to manage?
6. Risk Data and Systems	• Is there readily available, consistent, credible and sufficiently meaningful data? • What are the 'new' data elements that will be required for the organization, as well as it's suppliers, borrowers and other third-parties?
7. Risk Operating Model, People and Culture	• Has ownership and accountability for ESG risks been determined and is it linked with other risk types? • How are we monitoring and understanding the complex and evolving regulatory landscape? • Are we attracting and retaining resources with climate skillsets?

Polling question 4

To what extent do you believe your Internal Audit departments will increase its focus on ESG over the next 12 – 24 months?

a) Extremely confident
b) Very confident
c) Somewhat confident
d) Not so confident
e) Not at all confident

Presenters

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Thank you!

Any questions
or comments?

Appendix

ESG Reporting Standards

Regulatory and standard setting:

- **ESG regulatory action expected to increase under Biden/Harris administration:** rejoin Paris Agreement, US Net Zero by 2050, mandatory ESG disclosures for public companies
- **SEC** Modernizes Regulation S-K Disclosure Requirements—Human Capital Management
- **US Commodity Futures Trading Commission calls for regulatory action on climate** in Managing Climate Risk in the US Financial System report
- **US Federal Reserve** addresses climate risk and **joins** Network for Greening the Financial System
- **IFRS Foundation issues** Consultation Paper on Sustainability Reporting and announces next steps in response to broad demand for global sustainability standards
- **IOSCO** sees an urgent need for globally consistent, comparable, and reliable sustainability disclosure standards and announces its priorities and vision for a Sustainability Standards Board under the IFRS Foundation[1]
- **Acting Chair Allison Lee** issues a public statement to direct the Division of Corporation Finance to enhance its focus on climate-related disclosure in public company filings

Key ESG standard setting and reporting initiatives:

1. **GRI**
Global Reporting Initiative
2. **SASB**
Sustainability Accounting Standards Board
3. **TCFD**
Task Force on Climate-related Financial Disclosures
4. **SSE**
Sustainable Stock Exchange
5. **CDSB**
Carbon Disclosure Standards Board
6. **WBCSD**
World Business Council for Sustainable Development
7. **IIRC**
International Integrated Reporting Council
8. **UNGC**
United Nations Global Compact

Source: 1. International Organization of Securities Commissions (IOSCO)

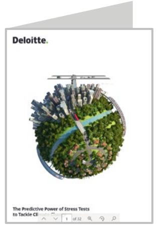
Selected ESG and Climate Risk Financial Services Deloitte publications

Creating a climate of change *Link*

ESG Integration, Risk Management

Point of view emphasizing the necessity of climate risk preparedness, arguing that US regulators, legislators, and investors aren't only demanding awareness, but also readiness and action as to how climate risk is prioritized within a bank's risk management framework.

The paper explores the increasingly aggressive regulatory landscape and evolving investor expectations and shares practical steps that banks can consider to establish plans for climate risk management.



The Predictive Power of Stress Tests to Tackle Climate Change *Link*

Risk Management, Stress Testing, Scenarios, Modeling

White Paper with a holistic outline of key climate risk management topics:

- Theoretical background on climate risk and definitions used in banking
- Current qualitative and quantitative practices/approaches in climate risk assessment
- Scenario analysis, stress testing
- Governance framework, ERM

Sustainable Finance Disclosure Regulation—Is the financial industry ready for the Big One? *Link*

Disclosure

90 firms in the scope of the EU Sustainable Finance Disclosure Regulation (SFDR) from 21 countries participated in a 2020 Deloitte survey, focusing on the

- Link between expected sustainability risk disclosures and the EU Taxonomy
- The balance between reporting and accountability,
- The relationship with current rating protocols and existing frameworks
- The readiness of NCAs or the potential evolution of ESG indicators.

The future of the Chief Sustainability Officer—Sense-maker in chief *(in collaborations with the IIF) Link*

Governance

Deloitte conducted a survey together with the Institute of International Finance (IIF), centering around the following key questions:

- What kinds of skills will firms need as they transition to a low-carbon economy?
- Which kinds of operating models are working best?
- Should all firms have a Chief Sustainability Officer (CSO)? If so, what should their role be and what forms of governance will empower them to succeed?

Creating a climate of change digest *Link*

Monthly climate risk regulatory developments in FSI

Climate-related risk stress testing in Asia *Link*

Climate-related risk stress testing in Asia

NYDFS sets climate risk expectations for New York-regulated financial institutions *Link*

Governance frameworks, risk management strategies in US

Climate change and banks: Questions Boards should be asking *Link*

Board of director considerations in UK/EU

Selected ESG and Climate Risk Disclosure Deloitte publications

The front line of ESG disclosure: the board's role *Link*

Disclosure

Analysis of recent developments that influence companies to improve transparency on ESG topics, and to consider the avenue for disclosure to most effectively meet the information needs of investors and other stakeholders.

The paper glances at some of the commonly cited standard setters and raters and rankers, demonstrating the fragmented state of sustainability disclosure that both companies and investors grapple within the current marketplace.

The atmosphere for climate-change disclosure *Link*

Disclosure

Paper emphasizing the need for boards and audit committees to be aware of the increased focus being placed on climate-change disclosures. They must determine how best to exercise their oversight role to respond to this focus.

This is underpinned by the recent momentum in discussions and debates about ESG disclosures. BlackRock and State Street are just two prominent examples in the asset management industry who announced voting action against ESG laggards.

Sustainability Disclosure Goes Mainstream *Link*

Disclosure

The article argues that transparency can be a tool to promote resilience and adaptability of an organization in response to growing demands for ESG performance information from multiple sources, most notably investors, customers, policy makers and regulators, and employees.

Companies should therefore more intentionally focus on high quality, credible disclosure that demonstrates a long-term strategy and greater preparedness for environmental and societal disruptions.

Climate-related risk assessments and financial disclosures *Link*

Disclosure

4-steps approach to tackle the challenges of the TCFD recommendations, including:

1. Identification and prioritization of key climate-related risks and opportunities
2. Analysis of tailor-made climate scenarios
3. Development of actions to mitigate risks
4. Communication and disclosure of climate-related risks and opportunities

Establishing science-based emissions reduction targets for insight, innovation, risk management, and competitiveness *Link*

Net zero transition

The paper finds that companies are accelerating their climate change agendas as they realize that such action offers opportunities to realize tangible business benefits. Yet while many companies continue to set absolute or intensity GHG emissions reduction target, these targets are usually arbitrary and typically conservative.

A science-based method removes the arbitrary approach and replaces it with a global benchmark to enable companies to set aggressive yet reasonable goals.

Selected ESG and Climate Risk Disclosure Deloitte publications

ESG moves to the main stage ***Link***

Disclosure

Article highlighting stakeholder expectations around ESG focused disclosures that are consistent, comparable and transparent.

The article emphasizes the criticality of demonstrating a commitment to ESG as it is no longer an organizational choice, but a crucial factor of doing business. Integrated ESG reporting means accounting for the impact of ESG-related information on financial statements or through separate disclosures.

How to approach ESG reporting: Part 1 *Link*

Disclosure

The first part of a three-part series describing recent developments in ESG reporting and how organizations can adapt and respond accordingly.

The article provides a summary of ESG reporting, its evolution and the impact it has on organizations today. There is a need for standardized ESG metrics and framework(s) established, for organizations to effectively prepare for ESG reporting.

How to approach ESG reporting: Part 2 *Link*

Disclosure

The second part of a three-part series outlining five (5) potential steps that organizations can take to report of ESG matters effectively.

Five (5) key steps to successful ESG reporting:

1. Set the foundation
2. Take stock
3. Implement controls and metrics needed to reach goals
4. Report on progress
5. Obtain assurance

How to approach ESG reporting: Part 3 *Link*

Disclosure

The last part of a three-part series emphases a critical component of meaningful ESG reporting: assurance

Publicly disclosed ESG information must be reliable, therefore, the article states that obtaining assurance on standalone ESG disclosures and metrics provides additional confidence in broader corporate disclosures beyond financial statement audits.

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