

Internal Audit's Role in Environmental, Social and Governance Matters



UHY Technical Webinar

July 10, 2024



Qualifying for CPE



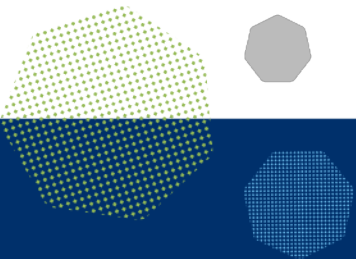
Remain in session for
50 minutes



Respond to
3 polling
questions

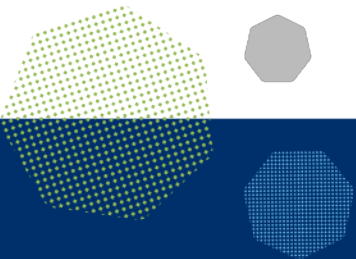


Complete
post-session
survey



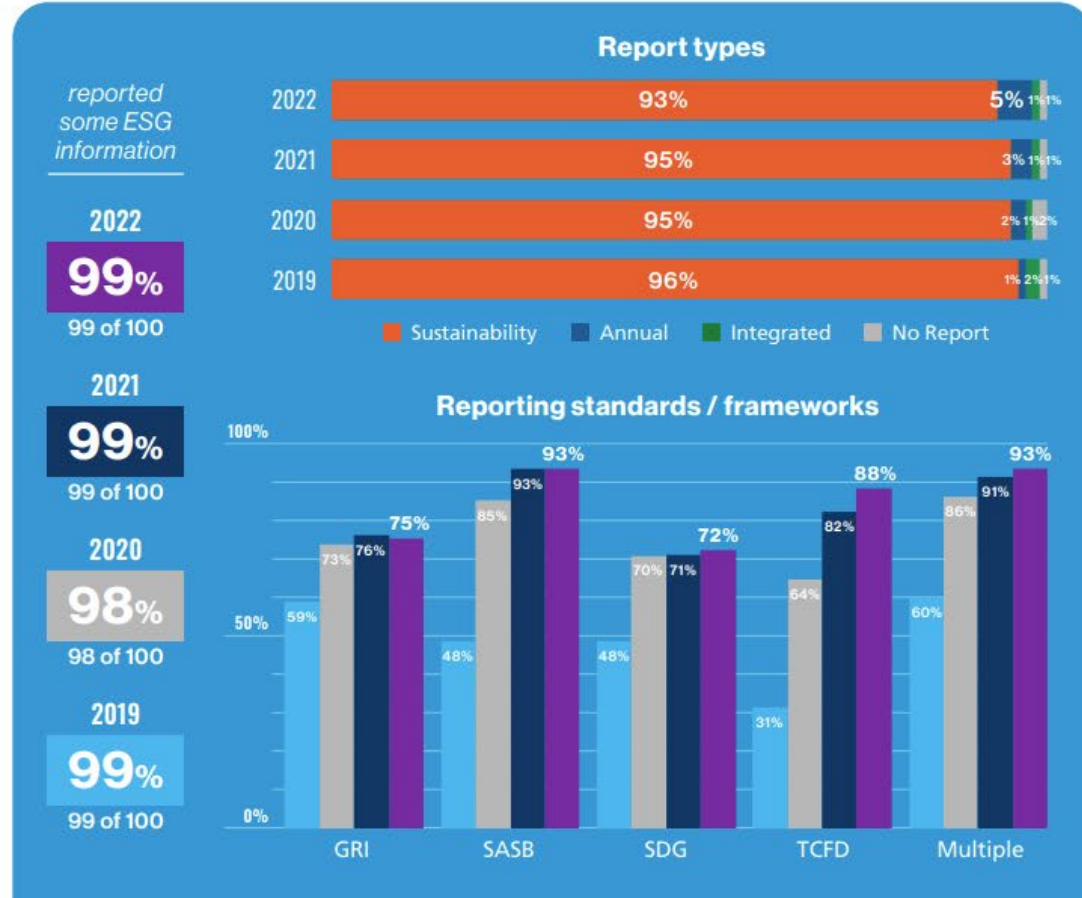
Receiving CPE Credit

- Credit processed **within 90 days after session**
 - UHY Colleagues: Credit and certificate available in LCvista
 - External Colleagues: Credit w/ certificate sent from “UHY CPE”
- Credit questions should be directed to **CPE@uhy-us.com**
- Recordings/materials available **24 hours after session**
 - UHY Colleagues: UHY University
 - External Colleagues: UHY’s event page

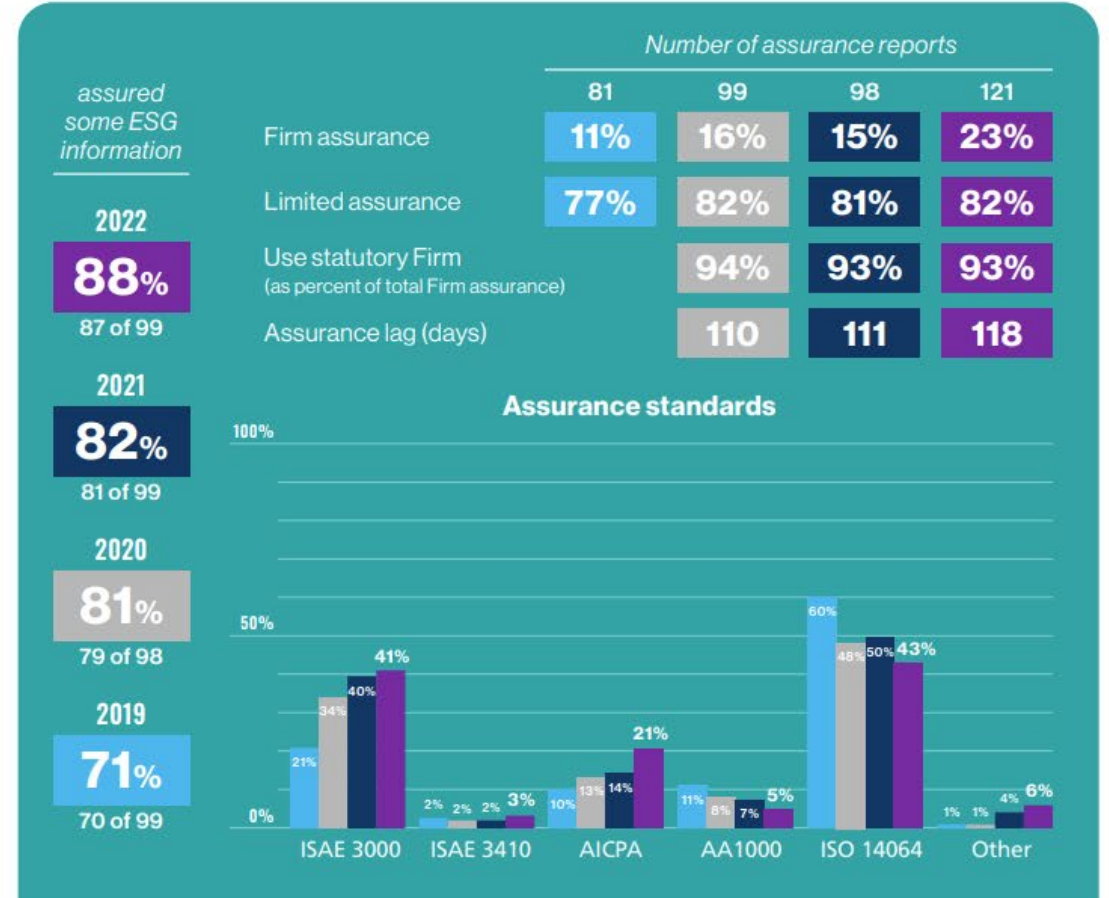


State of Play: 2019-2022 Trends in the U.S.

SUSTAINABILITY DISCLOSURE



SUSTAINABILITY ASSURANCE



* A company may have more than one assurance report

Source: The State Of Play: Sustainability Disclosure & Assurance published in February 2024 by the Association of International Certified Professional Accountants (International Federation of Accountants, AICPA & CIMA).

Learning Objectives

- Understanding alignment between corporate strategy and ESG strategy
- How does internal audit establish its role in ESG
- Internal audit's role in understanding the data compilation process (especially non-financial data)
- Creating processes and standards for unregulated, unstructured data that is much different from highly scrutinized financial data
- Data quality assurance (assessing the quality of the data used for decision-making)



What is ESG?

- **E**nvironmental matters relate to how nature impacts an organization or how an organization performs as a steward of nature.
- **S**ocial matters relate to how an organization manages its relationships with its employees, suppliers, resource providers, and community.
- **G**overnance matters related to the structure and processes of managing and controlling an organization.



Environmental



Social



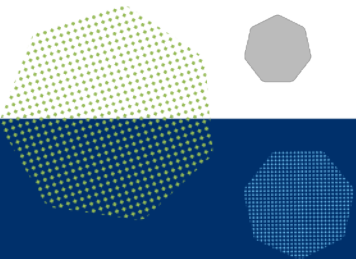
Governance

Environmental

- Ecological impact of totality of organizational operations
- Climate change
- GreenHouse Gas (GHG) emissions, include:
 - Scope 1: direct measures of an organization's activities
 - Scope 2: indirect measures from generation of purchased power
 - Scope 3: indirect measures of consumption that occur both upstream and downstream from organizational operations



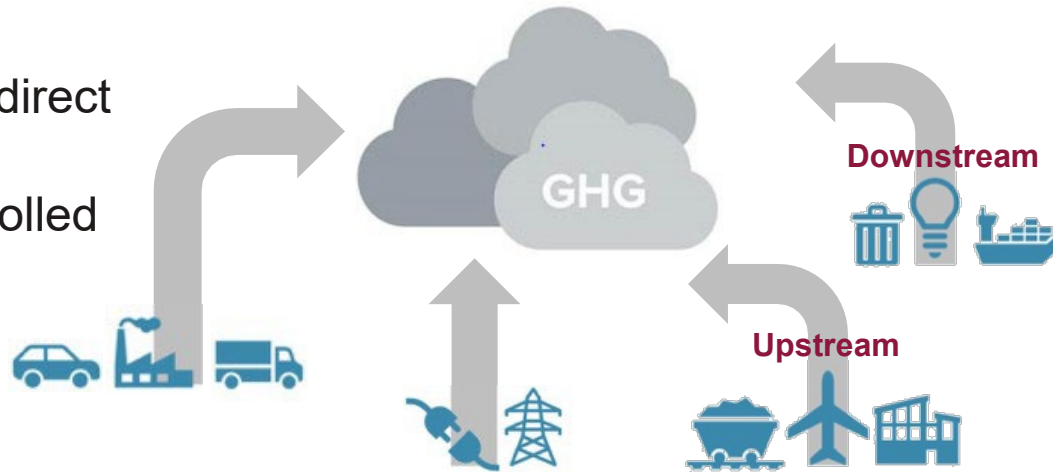
Environmental



Three Scopes of GHG Emissions

Scope 1

Emissions are direct emissions from owned or controlled sources.



Scope 2

Emissions are indirect emissions from the generation of purchased energy.

Scope 3

Emissions are all indirect emissions (not in Scope 2) that occur in the reporting company's value chain, including upstream and downstream emissions from the generation of purchased energy.

Scope 3 emissions can account for 65% to 95% of emissions.

Upstream Sources	Downstream Sources
<ul style="list-style-type: none">• Purchased Goods• Capital Goods• Fuel & Energy• Transportation• Waste from Ops• Business Travel• Commuting• Leased Assets	<ul style="list-style-type: none">• Investments• Lease Assets• End-of-life allotting• Use of Sold Goods• Transportation

Social

Internal

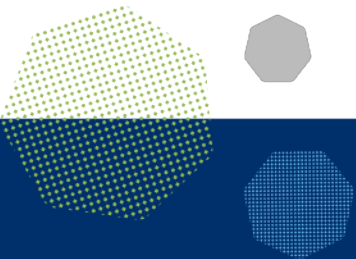
- Employee demographic data
- Health and safety
- Labor practices

External

- Population demographic statistics
- Community engagement
- Sales practices



Social



Governance

- Board structure
 - Including committees and sub committees
 - Ownership of ESG processes (CSO, Legal, IA, Finance, etc.)
- Annual budget process
- Leadership integrity and diversity
- Audit reports and results
- Compensation and benefits data
- Conflicts of interest disclosure
- Accountability to shareholders/stakeholders



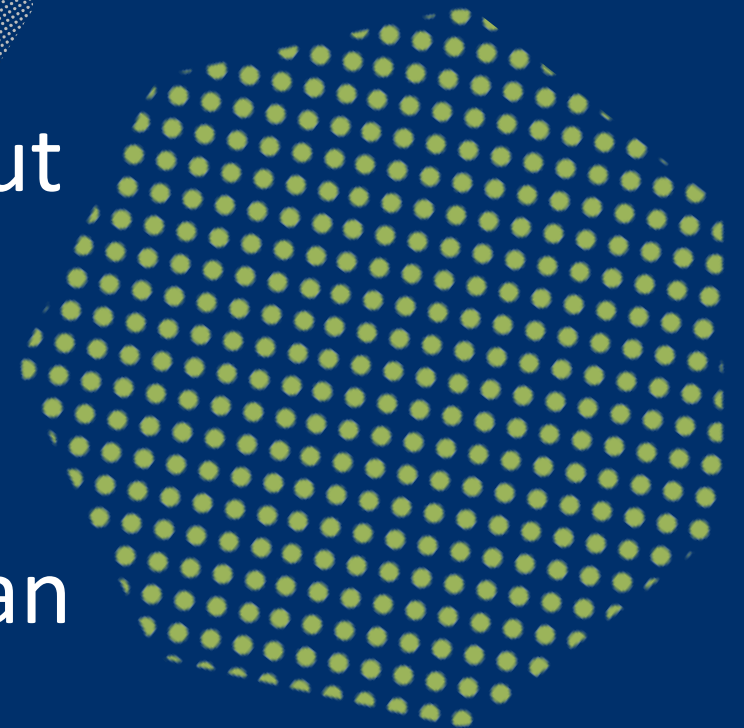
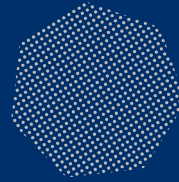
Governance



Polling Question 1

Is ESG a priority for your organization?

- A. **No** – We don't talk about it.
- B. **Somewhat** – We've discussed it, but have yet to take action.
- C. **Yes** – We are in the process of addressing.
- D. **Absolutely** – We already have a plan in place.



ESG Concepts are Familiar to Internal Auditors



Internal Audit has experience providing value in each of the areas because they present risk to the organization and support business strategy

What is new?

- Combining these topics under one framework perhaps with multiple reporting and assurance requirements, called ESG!
- Increasing stakeholder interest
- Transparency and comparability requirements on these topics

What is Internal Audit's Role?



Assessment of Process

Assess processes, ensuring that they are efficient and effective, including:

- Internal Controls
- Benchmarking and Maturity Assessments
- Regulatory Compliance Processes



Data Quality Assessment

Assess the quality of data, which is essential for making informed business decisions. In general data quality is difficult to assess re: ESG due to immature processes and difficulty accessing certain data



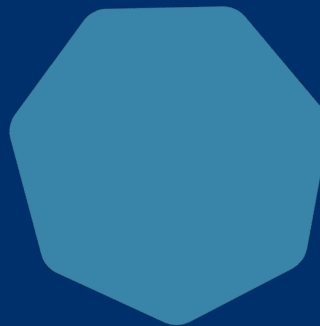
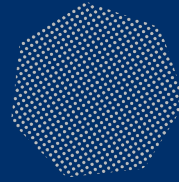
Alignment with Strategic Goals

Ensure that ESG practices are aligned with the organization's strategic goals, enterprise risk management activities, future commitments, etc.

Polling Question 2

What is your current role at your employer?

- A. Internal Audit
- B. ESG or Sustainability related
- C. Finance or Accounting
- D. Operations
- E. Other



ESG related COSO Guidance

- Achieving Effective Internal Control of Sustainability Reporting (ICSR 2023)
- References the role of the internal audit function
- Contains “Insights” from leading companies
- Breakdown of the COSO cube and each of the common COSO Principles as it relates to sustainability



*Released March 2023

ERM and ESG



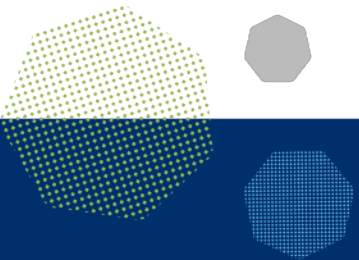
Governance and Culture

- Governance provides the oversight, structure and culture needed to establish an organization's strategies and objectives
- Map or define the organization's mandatory or voluntary ESG-related requirements
- Consider opportunities for embedding ESG in the entity's culture and core values
- Be informed of the ways to increase board awareness of ESG-related risks



Governance and Culture

- Map the operating structures, identify owners for ESG-related risks and controls, and end-to-end ERM and strategic planning process to identify areas for improved oversight and collaboration
- Create opportunities for collaboration throughout the organization
- Embed ESG-related skills, capabilities, and knowledge in hiring and talent management to promote integration



ESG Strategy



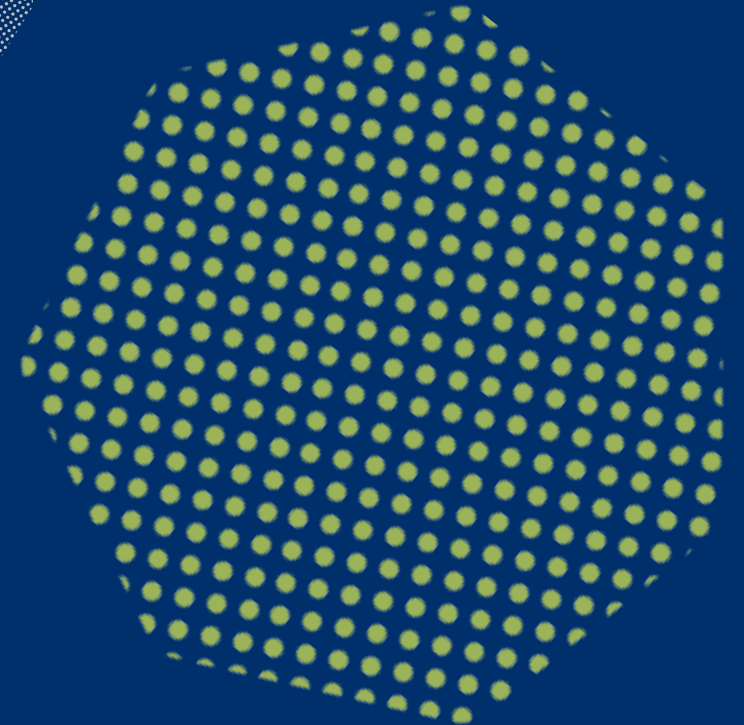
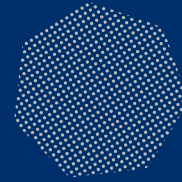
Gain an understanding of organizations' strategy and objectives. To assist with this understanding, conduct:

- Megatrend analysis to understand the impact of emerging issues in the external environment
- Strengths, weaknesses, opportunities, and threats (SWOT) analysis
- An ESG materiality assessment to describe significant ESG issues
- Engagement with internal and external stakeholders to understand emerging ESG trends
- Analysis leveraging ESG-specific resources

Polling Question 3

Has your organization and/or audit function performed a risk assessment that incorporates ESG-related data?

- A. Yes, it's complete.**
- B. Yes, but we want to make some changes to our approach.**
- C. No, but we are planning one.**
- D. No, have no plans to do so.**



Identify ESG Risk

- Sources for identification
 - Sustainability function
 - Prior internal and external audits
 - Surveys
 - Workshops
 - Interviews with executives
 - Media monitoring
 - Data tracking and analysis of events
 - Monitoring regulatory changes
- Examine the entity's risk inventory to determine which ESG-related risks have or have not been identified



- 1  GOVERNANCE & CULTURE FOR ESG-RELATED RISKS
- 2  STRATEGY & OBJECTIVE-SETTING FOR ESG-RELATED RISKS
- 3  **PERFORMANCE FOR ESG-RELATED RISKS**
 - a IDENTIFIES RISK
 - b ASSESSES & PRIORITIZES RISKS
 - c IMPLEMENTS RISK RESPONSES
- 4  REVIEW & REVISION FOR ESG-RELATED RISKS
- 5  INFORMATION, COMMUNICATION & REP FOR ESG-RELATED RISKS



Identify ESG Risk

Example of risk inventory/risk register

Strategic	Operational	Financial	Compliance
<ul style="list-style-type: none">• Vision and core values• Corporate governance• Organizational structure• Strategic planning• Mergers and acquisitions valuation and pricing• Investor relations• Competition• Changing customer preferences or lifestyles• Growing middle class• Urbanization/growing population• Emerging markets	<ul style="list-style-type: none">• Research and development• New products• Marketing• Budgeting and forecasting• Raw material availability• Suppliers• Production management• Product stewardship• Inventory management• Employee engagement• Labor relations• Human rights• IT investment• Cybersecurity• Business continuity• Pandemic• Physical impacts of climate change	<ul style="list-style-type: none">• Interest rate volatility• Foreign currency volatility• Cash management• Credit risk• Accounting policies• Accounting estimates• Internal control• Tax strategy and planning	<ul style="list-style-type: none">• Fraud• Bribery• Conflicts of interest• Country/state/local regulation• Tax regulation• Trade regulation• IP management and protection• Greenhouse gas emissions• Water treatment• Health and safety

Identify ESG Risk

Example of risk & opportunities matrix

Type	ESG-related risk or opportunity	Environmental	Social	Governance
Strategic	• Shifting customer preferences toward products that are manufactured with ethical supply chains		■	
	• Growing investor interest in ESG issues, resulting in proxy voting against the company on a range of topics (e.g., diversity, deforestation and human rights)	■	■	■
Operational	• Increased cost of raw materials due to sustainable forestry practice requirements	■		
	• Reduction of waste and raw material costs through improved manufacturing processes	■		
	• Changing weather patterns and increased natural disasters disturbing operations and business continuity	■		
Financial	• Reputation impacts and societal concerns due to a tax avoidance strategy and lack of tax transparency		■	■
	• Investment in local content to generate sustained and inclusive growth through economic diversification and employment opportunities		■	
	• Increased taxation from carbon tax regulation	■		
Compliance	• Enhanced reporting requirements for greenhouse gas emissions and energy usage	■		
	• Inaccurate or fraudulent disclosure of emissions resulting in fines and penalties and loss of consumer trust	■		■

Identify ESG Risk



- Define the impact of ESG-related risks on the organization precisely.
- Involve sustainability practitioners in the risk identification process to leverage subject-matter expertise
- Use root cause analysis to understand the drivers of the risk
- When identifying, consider:
 - Is there data behind the risk?
 - Is the data complete and accurate?
 - Are there IT controls around the data source (upstream, downstream)?



- 1  GOVERNANCE & CULTURE FOR ESG-RELATED RISKS
- 2  STRATEGY & OBJECTIVE-SETTING FOR ESG-RELATED RISKS
- 3  **PERFORMANCE FOR ESG-RELATED RISKS**
 - a IDENTIFIES RISK
 - b ASSESSES & PRIORITIZES RISKS
 - c IMPLEMENTS RISK RESPONSES
- 4  REVIEW & REVISION FOR ESG-RELATED RISKS
- 5  INFORMATION, COMMUNICATION & REP FOR ESG-RELATED RISKS

Assess and Prioritize ESG Risk

- Leverage subject-matter expertise to prioritize ESG-related risks
- Understand the entity's criteria for prioritizing risks
 - Quantitative and Qualitative

Measure	Example risk severity metrics
Quantitative (monetary) 	Revenue: Projected or identified impact on revenue or expenditures Expenditures: Projected or identified impact on expenditures or costs EBITDA: Projected or identified impact on EBITDA Assets and liabilities: Write-off, asset impairment and early retirement of existing assets Capital and financing: Impact to cost of capital or access to capital, operating losses Share price: Impact (%) in share price ^c Customer/reputation: Reduction in customer confidence (%) (may also be measured in revenue) Safety: Lost time due to injuries
Quantitative (non-monetary) 	Social media coverage: Number of viewers of the entity's video Business continuity: Maximum allowable outage Greenhouse gas emissions: Total emissions by type of greenhouse gas (GHG); carbon intensity (GHG/USD \$ million) Energy/fuel: Total energy consumption in megawatt hours Water: Total freshwater withdrawn in cubic meters from water-stressed regions Land use: Percentage change in land cover type (e.g., grassland, forest, cultivated, pasture, urban) Location: Number of locations within a designated flood zone Capital and financing: Increase or decrease in ability to raise capital Reputation: Type of complaints received from stakeholders ^d
Qualitative	Staff morale/turnover: Engagement survey results/level of engagement

Assess and Prioritize ESG Risk

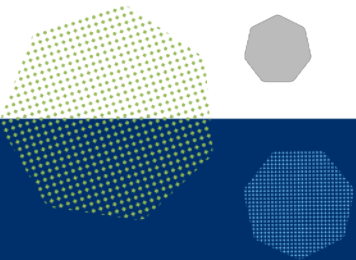
- Understand the metrics used by the entity to measure risk severity
 - Risk severity = Impact and Likelihood
- Example of impact criteria

Risk rating	Definition
Catastrophic	<ul style="list-style-type: none">• Financial loss: []% of earnings before interest, taxes, depreciation and amortization (EBITDA) or more than []% impact on share price• International negative media coverage for more than six months that results in at least []% revenue loss• More than []% employee turnover• Prosecution, fines and litigation greater than []% of expenses• Threatened or actual loss of []% or more strategic customers
High	<ul style="list-style-type: none">• Financial loss: []% of EBITDA or share price• Reputation damage from media coverage that persists for one to six months and results in []% nonrecurring revenue loss• Results from employee survey showing staff morale more than []% less than peer organizations• Threatened or actual loss of []% strategic customers
Medium	<ul style="list-style-type: none">• Financial loss: []% of EBITDA or share price• Reputation damage from media coverage that persists for less than one month and results in []% nonrecurring revenue loss• Results from employee survey showing morale []% less than peer organizations• Threatened or actual loss of []% strategic customers
Low	<ul style="list-style-type: none">• Financial loss: less than []% of EBITDA or share price• Local reputation damage from NGO or media resulting in less than []% revenue loss• Individual feedback from employees on low staff morale• Customer complaints from less than []% of strategic customers

Assess and Prioritize ESG Risk

Example of likelihood criteria

Risk rating	Definition
Very high	<ul style="list-style-type: none">• Once a year or more frequent• More than []% chance of occurring
High	<ul style="list-style-type: none">• Occurs once every 1-3 years• []% chance of occurring
Medium	<ul style="list-style-type: none">• Occurs once every 3-5 years• []% chance of occurring
Low	<ul style="list-style-type: none">• Occurs once every 5-10 years• Less than []% chance of occurring



Assess and Prioritize ESG Risk

- Select and document data, parameters, and assumptions
- Prioritize the risks
- Identify and challenge organizational bias against ESG issues

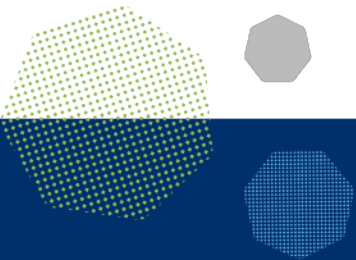
Aspect	Considerations
Data sets	<ul style="list-style-type: none">• What primary or secondary data is available as an input to the measurement tool?• What tools and frameworks can be used to support ESG-related risk assessments?• What assumptions are inherent in the selected data?• How reliable is the data?• Does the data apply to the defined scope of the risk?
Timing	<ul style="list-style-type: none">• What time period should the analysis consider (e.g., strategic plan; 5, 15 or 30 years)?
Scope	<ul style="list-style-type: none">• At which organizational levels (e.g., divisions, functions and operating units) and value chain (inputs, operations and markets) is the analysis applied?
Discount rate	<ul style="list-style-type: none">• How certain are the expected events and timing of cash flows used in the monetary estimate?• Are these estimates established with enough subject-matter expertise or historical evidence to apply a discount rate?

Implement ESG Risk Response

- Recommend appropriate risk response or control activities based on entity-specific factors (e.g., costs and benefits and risk appetite)
- Convert risks into opportunities
- Develop the business case for the response (recommendation) and obtain buy-in
- Evaluate risk responses at the entity level to understand the overall impacts on the entity risk profile



- 1  GOVERNANCE & CULTURE FOR ESG-RELATED RISKS
- 2  STRATEGY & OBJECTIVE-SETTING FOR ESG-RELATED RISKS
- 3  **PERFORMANCE FOR ESG-RELATED RISKS**
 - a IDENTIFIES RISK
 - b ASSESSES & PRIORITIZES RISKS
 - c **IMPLEMENTS RISK RESPONSES**
- 4  REVIEW & REVISION FOR ESG-RELATED RISKS
- 5  INFORMATION, COMMUNICATION & REI FOR ESG-RELATED RISKS



Review/Revise ESG Risk



- Identify and assess internal and external changes that may substantively affect the strategy or business objectives
- Review ERM activities to identify revisions to ERM processes and capabilities
- Pursue improvements in how ERM manages ESG-related risks

Report ESG Risks and Responses

- Identify relevant information and communication channels for internal and external communication and reporting
- Communicate and report relevant ESG-related risk information internally for decision-making
- Communicate and report relevant ESG-related risk information externally to meet regulatory obligations and support stakeholder decision-making
- Continuously identify opportunities for improving the quality of ESG-related data reported internally and externally



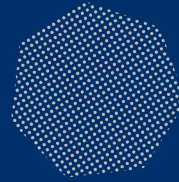
- 1  GOVERNANCE & CULTURE FOR ESG-RELATED RISKS
- 2  STRATEGY & OBJECTIVE-SETTING FOR ESG-RELATED RISKS
- 3  PERFORMANCE FOR ESG-RELATED RISKS
 - a IDENTIFIES RISK
 - b ASSESSES & PRIORITIZES RISKS
 - c IMPLEMENTS RISK RESPONSES
- 4  REVIEW & REVISION FOR ESG-RELATED RISKS
- 5  **INFORMATION, COMMUNICATION & REPORTING FOR ESG-RELATED RISKS**



Polling Question 4

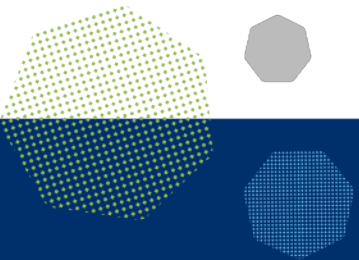
What type of internal audit project would be valuable at your organization?

- A. Data Validation Assessment**
- B. Internal Controls Review**
- C. Governance Assessment**
- D. Benchmarking and Maturity Model Review**
- E. Regulatory Compliance**



Assessment of Process

- What data is being gathered?
 - Internal
 - External
- How frequently is data being gathered?
- Who is gathering the data?
- How is the data being gathered?
 - Segregation of duties
 - Integrated into procurement contracts for scope 3?



Assessment of Data Quality



Relevant

Data is directly related to the objectives or goals



Reliable/Replicable

Data can be consistently reproduced or verified



Timely

Data is up-to-date and reflects the current state



Inclusive

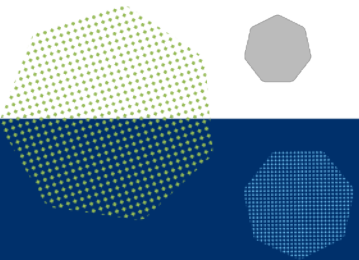
Data captures both positive and negative aspects



Alignment with Strategic Goals



- 1 Operating Budget
- 2 Capital Budget
- 3 Long-Term Strategic Plan



Value Added Opportunities



Feedback

Provide constant feedback on the data-gathering process



Audits

Conduct spot audits of financial and non-financial ESG data

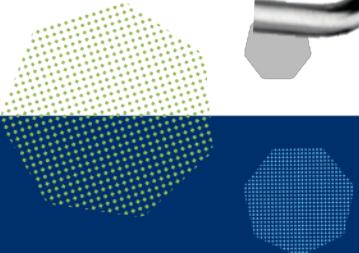


Integration

Assess integration of ESG reporting items into strategic documents



Recapping Internal Audit's Role



Q&A

Mike Poveda

National ESG Leader

518 694 5945 | mpoveda@uhy-us.com

Jack Reagan

National Government Practice Leader

410 423 4832 | jreagan@uhy-us.com

David Plajstek

Principal, Risk Advisory Services

313 919 3007 | dplajstek@uhy-us.com

Reina Hernandez

Manager, Risk Advisory Services

410 423 3502 | rhernandez@uhy-us.com



About UHY

UHY is one of the nation's largest professional services firms providing audit, tax, consulting and advisory services to clients primarily in the dynamic middle market. We are trailblazers who bring our experience from working within numerous industries to our clients so that we can provide them a 360-degree view of their businesses. Together with our clients, UHY works collaboratively to develop flexible, innovative solutions that meet our clients' business challenges. As an independent member of UHY International, we are proud to be a part of a top 20 international network of independent accounting and consulting firms.



UHY-US.COM | An independent member of UHY International





We Serve You Where You Work

For a complete listing of our U.S. offices, please visit: www.uhy-us.com/locations

GLOBAL

As an independent member of UHY International, we are proud to be a part of a top 20 international network of independent accounting and consulting firms. For a complete listing of our member firms, please visit: www.uhy.com/locations

UHY LLP is a licensed independent CPA firm that performs attest services in an alternative practice structure with UHY Advisors, Inc., and its subsidiary entities. UHY Advisors, Inc.'s subsidiaries, including UHY Consulting, Inc., provide tax and business consulting services through wholly owned subsidiary entities that operate under the name of "UHY Advisors" and "UHY Consulting". UHY Advisors, Inc., and its subsidiary entities are not licensed CPA firms. UHY LLP, UHY Advisors, Inc. and UHY Consulting are U.S. members of Urbach Hacker Young International Limited, a UK company, and form part of the international UHY network of legally independent accounting and consulting firms. "UHY" is the brand name for the UHY international network. Any services described herein are provided by UHY LLP, UHY Advisors and/or UHY Consulting (as the case may be) and not by UHY or any other member firm of UHY. Neither UHY nor any member of UHY has any liability for services provided by other members.

