Climate change and sustainability

Five highly charged risk areas for Internal Audit

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Five highly charged risk areas for Internal Audit

Climate change and sustainability are fundamental business issues in today's emerging low-carbon scenario in India. This not only opens up new opportunities for organizations to increase their revenue and reduce costs, but also emphasizes the need for them to manage a wide variety of new risks. For the Internal Audit function, identifying and understanding these risks and how they affect the organization is critical — as is its role in helping to evaluate the results of climate change and sustainability initiatives, and reporting when the results do not meet a company's objectives.

Accuracy in monitoring, measuring and reporting the results of climate change actions is becoming increasingly important to internal and external stakeholders. As a result, the evaluation of management's climate change and environmental agenda and disclosures is a topic of wide-ranging discussion for the disclosure committee, the audit committee and the board of directors of an organization.

Why now?

A number of forces have combined to increase interest in climate change and sustainability-related issues, including:

- Better public access to information, improved media coverage of issues and higher expectation of corporate transparency
- High-profile incidents in the workplace, including major spills, process safety incidents and human rights allegations
- Shifting consumer expectations and behavior
- Business partner expectations and competitors' activities, with market conditions requiring that companies keep up a fast pace in this area
- The introduction of more stringent regulations in line with India's commitment to reduce carbon emission intensity between 2005 and 2020, as well as the perform, achieve, trade (PAT) scheme, etc.
- Greater engagement of the investment community, including the publication and popularity of international indices (e.g., Dow Jones Sustainability Indexes)
- Employee expectations — employees increasingly indicating that it is important that their employers are "responsible" to society and the environment

Strategic
Compliance
Internal Audit
Operational
Financial
Reputational

1. Strategic

Companies face a myriad of strategic climate change and sustainability risks, such as market positioning, changing consumer preferences, strategic investments (e.g., in cleantech and renewable energy) and stakeholder communications/investor relations, given that they are now being valued on their climate change performance. However, they should not just focus on what could go wrong. Senior management and the board should be asking, "Where do climate change and sustainability risk indicate opportunities for competitive advantage?" Producing new green products or entering new markets carries risks, but some companies may be better equipped to manage such risks and capitalize on them to gain a competitive advantage. In other words, risk management is closely linked to overall corporate strategy. Leading companies understand this link and are finding ways to turn climate change risks into opportunities.

Questions Internal Audit should ask

- Has the company's management discussed with its board the importance of a climate change and its sustainability strategy ?
- Does the organization fully grasp the strategic implications of climate change risk to it and are enterprise-wide programs in place to define, monitor and assess these risks?
- Does the Internal Audit team have the necessary skills and people to evaluate these new risks?
- Are climate change and sustainability risks captured in the company's enterprise-wide risk-assessment process?

What this means for Internal Audit

Internal Audit needs to have a seat at the table when climate change and sustainability strategies are being determined. This will ensure that key risks are identified and prioritized and are a recognized part of the Internal Audit plan of a company and its overall risk management (with its climate change and sustainability-related risks being incorporated into its risk register).

An organization's entire sustainability program needs to be audited to ascertain that the program is not only meeting all its established goals and targets, but also its voluntary commitments (e.g., the United Nations Global Compact, Carbon Disclosure Project, Sustainability Strategy, etc)

2. Compliance

Many companies are facing new and expanding regulatory compliance risks resulting from an increasing number of international, national and regional programs. In a recent Ernst & Young study, 1 of 300 global executives from organizations with revenues of US$1 billion or more, 94% of the respondents saw national policies as important or very important in shaping their climate change strategies, and 81% recognized the importance of global or international policies. In the past year alone, over 250 climate change-related government actions were implemented globally. For instance, the proposed PAT scheme under the National Mission on Enhanced Energy Efficiency (NMEEE) of the Government of India not only opens up new regulatory compliance risks for companies, but also financial and reputational ones, given that specific facilities are under the microscope.

The key risk areas resulting directly or indirectly from regulatory measures are varied and can include health, safety, human rights, labor laws, anti-bribery, and environmental risks. Environmental risks can include the direct impact (e.g., efficiency cost exposure) and indirect impact (e.g., energy price increases and accompanying reporting and compliance costs). In addition, Audit and verification activities are required in certain programs, resulting in additional cost exposure. Companies in unregulated jurisdictions face additional risks around policy uncertainty.

In the US, the SEC has recently provided public companies with interpretive guidance on existing SEC disclosure requirements. The SEC's interpretive guidance highlights the following areas as examples of areas in which climate change may trigger disclosure requirements:

- Effect of legislation and regulation: When assessing potential disclosure obligations, a company should consider whether the effect of certain existing laws and regulations relating to climate change is material. In certain circumstances, a company should also evaluate the potential effect of pending legislation and regulation.
- Effect of international accords: A company should consider, and disclose where relevant the risks or effect on its business of international accords and treaties relating to climate change.
- Indirect consequences of regulation or business trends: Legal, technological, political and scientific developments pertaining to climate change may create new opportunities or risks for companies.

What this means for Internal Audit

Internal Audit needs to demonstrate to the management of a company the importance of issues and the identification and management of potential risks. More than ever, boards need to have confidence in the processes that are in place in their companies to manage climate change and sustainability-related risk. Internal Audit also needs to provide assurance that the organization is meeting its compliance obligations in all the jurisdictions in which it operates. Internal Audit also needs to monitor and assess the impact of existing and proposed legislation.

- Physical effect of climate change: Companies should also evaluate, for disclosure purposes, the actual and potential material effect of environmental issues on their business.

Questions Internal Audit should ask

- Does the company have its business processes in place to identify and monitor its regulatory mandates relating to the environment, health, safety, community development and ethical behavior?
- Are the company's climate change and sustainability risks objectively reflected in its internal and public reporting?
- Are processes in place to enable the company to capture all the available tax and non-tax incentives related to its climate change capital spending?
- Does the organization fully understand climate change regulations in every jurisdiction in which it operates?
- How is the organization managing risk in cases where policy and regulation are not clearly defined?
- Does the board or audit committee of the company have the appropriate perspective of climate change and the sustainability of external reporting and disclosures?
- Is the company's board confident that its management has a clear understanding of the regulatory initiatives underway in the organization?
- Does the board understand how these could affect the company's risk profile?

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3. Financial

Increasingly, CFOs have an important role in an organization in terms of creating and driving climate change and sustainability strategy in it. These issues directly and indirectly affect the share price value through issues such as new compliance costs, the corporate ranking of analysts based on their sustainability performance and new marketplace risks. A company can lose its customers and market share if it does not respond promptly and adequately to climate change risks and opportunities.

For most industries, transition to a lower carbon process means reduced energy costs. In addition, carbon-intensive sectors may face an increase in their cost of capital as financial institutions begin to factor carbon into their lending procedures. New regulations, rapidly evolving technologies and changing customer preferences are all contributing to pressures on shareholder value. Combined, these issues are affecting how companies are valued. Consequently, they are becoming increasingly important in the due diligence of proposed merger and acquisition deals.

Another critical CFO issue relates to external reporting. Investor groups are exerting more pressure on companies to report transparently on their climate change and sustainability performance — shareholder actions on this subject were up 40% in 2009. As external stakeholders increase this pressure, companies need to have systems and processes in place to collect the relevant data to respond to the former. Decisions need to be made as to what information should be disclosed in the annual report and what should be disclosed in reports outside registration statements. All of this leads to audit committees increasingly needing to know that the information reported across multiple formats is robust, accurate and complete. Transparent reporting is also a critical element in controlling reputational risk.

Questions Internal Audit should ask

- What management systems and internal controls are in place in a company to identify, monitor and quantify the risks and opportunities of climate change and sustainability-related issues?
- Does the organization have robust fiscal controls in place to manage this fast-growing spend?
- What effect will emerging compliance obligations to reduce emissions have on the cash management and liquidity of the organization?
- Has the organization decided on what is material for its non-financial reporting purposes?
- Are key performance indicators (KPIs) and assignment of risk responsibility measures in place in the company?

What this means for Internal Audit

A substantial majority (70%) of the global executives surveyed in the Action amid Uncertainty survey plan to increase their climate change spend between 2010 and 2012. According to nearly 50%, they will spend 0.5% of their revenues on climate change initiatives; some plan to spend more than 5%. With revenues of US$1 billion or more, at the minimum, this represents anticipated spends of US$5 million to US$50 million annually.

For Internal Audit, this means that there will be an increasing need for robust controls as organizations focus on reducing costs, generating new revenue streams and reducing risk. The study further reveals that their priorities reflect a mix of short- and medium-term business goals such as the following:

- 82% of executives plan to spend on energy efficiency
- 65% have plans to invest in the development of new products and services
- 64% now report their greenhouse gas emission data in their annual reports

4. Reputational

What this means for Internal Audit

Internal Audit needs to assure the management of a company about the integrity, consistency and timeliness of its externally reported information. Executives and boards are acutely aware of the growing demand for more transparent reporting of climate change and sustainability business strategies, initiatives and performance. Therefore, companies are now using many voluntary reporting channels, including external sustainability and annual reports, external websites, the Carbon Disclosure Project and the Climate Registry. Internal Audit can assist in evaluating the accuracy and credibility of sustainability reporting in advance of the increasing scrutiny this information is attracting from external stakeholders.

In the Ernst & Young survey previously cited, 64% of respondents currently communicate data on greenhouse gas or carbon emissions in an annual corporate social responsibility report or sustainability report. Nearly a third indicate that their organizations have not yet communicated this data publicly. The risk for those not communicating their climate change data is that their stakeholders will seek this information from potentially less-reliable third party sources.

Companies that do not report face challenges in ensuring that their reports are an effective communication tool. The information needs to be relevant, complete and in line with the expectations of stakeholders. Done well, it provides a company with the opportunity to present a clear picture of the measures it is taking to meet the challenges and opportunities of climate change. Some leading organizations are beginning to include their integrated financial and non-financial data in a single report, which helps readers to better understand the full financial implications of their organizations' business strategy. In our survey, 62% of the respondents reported that they have their data verified by independent third parties. The publication of an assurance statement with the sustainability report is an increasingly common approach to enhance a company's credibility and to meet the growing stakeholder demand for transparency.

One of the key challenges many companies face is managing the expectations of their stakeholders – including investors, employees, customers, suppliers, local communities and the media – to reduce risk. Analysts are also beginning to value companies, based on their sustainability performance, thereby creating new reputational risks. In Action amid Uncertainty, more than 40% of the respondents believe that equity analysts currently include climate change-related factors in company valuations. Climate change and sustainability performance is also linked to customer satisfaction and loyalty, strong supplier relationships, and attracting and retaining of top talent. Given the multitude of stakeholders exerting pressure on companies to manage their risk and seize opportunities in this area, there has been a significant increase in their external reporting. More than 1,200 companies worldwide (about 50 in India) now issue sustainability reports, based on the Global Reporting Initiative (GRI).

Momentum is steadily building up for more integrated reporting of financial and non-financial information related to climate change and sustainability. Being prepared for this shifting environment will be of paramount importance, going forward. Managing stakeholder expectations is another area where risk can become an opportunity to increase brand and shareholder value.

Questions Internal Audit should ask

- What is the current perception of the organization's stakeholders – investors, customers, employees – about its eco-friendliness?
- Is its reputational risk at the top of its agenda when the company is putting in place its climate change policy?
- Has its management fully evaluated the ripple effects of negative customer satisfaction, shareholder activism or ineffective public disclosures and communications?
- Is the organization's reported data assured by an independent third party?
- Is Internal Audit working with the organization's external auditors to create transparent reporting of non-financial data?
- Does the company currently have adequate controls and processes in place in anticipation of the possibility that proposed regulations may require the inclusion of climate change information in annual reports?

5. Operational

One of the greatest challenges for companies in implementing their climate change and sustainability strategies includes implementing these across their operational business units and key functional areas. These include IT, supply chain and facilities. Climate change and sustainability-related issues are associated with physical risks linked to the physical impact of climate change. These can result in damage to infrastructure and assets, reduced asset life and increased maintenance expenses, which can increase insurance premiums. Another significant operational risk is the rising cost of energy, which is one of the largest operating expenses for many companies. An organization's response to climate change and carbon reduction — a risk area — is also an opportunity to reduce its energy costs through the implementation of efficiency measures.

Value chain risk associated with customers and suppliers is a growing operational risk area. Everyone is part of someone else's supply chain. Many companies are working directly with their suppliers with the expectation that the latter will provide their customers with sustainability performance information, including their carbon footprint, and information relating to water and waste and sustainable labor policies. Some companies are now required to complete a lifecycle greenhouse gas assessment of their products and provide this information to their customers. Some are also being asked to disclose their plans relating to reductions in their carbon content and costs. For all these reasons, companies are now focused on their supply chain as a risk area and an opportunity to enhance their operational efficiency.

Questions Internal Audit should ask

- What standards are being used for measurement in the company?
- Has the company estimated how a small long-term change in its weather-related patterns or energy costs would affect its entire supply chain and margins?
- Are there adequate project management measurements in place in the organization?
- Has it completed a lifecycle greenhouse gas assessment of its products and/or services?

What this means for Internal Audit

Some of the biggest climate change-related risks and opportunities for companies exist within their supply chains. Many organizations are therefore already driving their climate change and sustainability strategies and greenhouse gas reduction goals through their supply chains. In our survey, approximately 66% of the respondents are discussing climate change programs with their suppliers and 36% are already working directly with their stakeholders to decrease carbon in their supply chains. Identifying supply chain risks and opportunities that arise from climate change can help to achieve the following:

- Mitigate risks to supply continuity
- Get products and services to market more efficiently
- Align brand value with changing customer demand
- Internal Audit will also need to:
- Assure the organization that it is complying with all the requirements of its environmental management system
- Evaluate whether there is adequate benefit realization from the organization's climate change and sustainability initiatives and ascertain that these are on time and transparent as far as their budgets are concerned

Ten actions Internal Audit should take

Internal Audit's main role is to provide objective assurance to the board and executive management of a company that its key risks are being managed effectively and in accordance with its internal and external obligations. For climate change and sustainability-related issues, this mandate can be complied with through the following 10 actions:

Sl. no.	Action
1.	Embed climate change and sustainability as part of the Internal Audit risk assessment of the company
2.	Understand and assess its key climate change and sustainability risks — strategic, compliance, financial, reputational and operational
3.	Validate that the organization's key climate change and sustainability risks are appropriately identified, prioritized and controlled within each of its business units or processes audited
4.	Review its processes for climate change and sustainability reporting, and evaluate the integrity and alignment of the company's data across all its reporting channels
5.	Share insights with the management and the board so they have a clear understanding of the regulatory environment complexities existing in the organization
6.	Coordinate the company's climate change and sustainability risk assessment with its other key risk functions
7.	Review its corporate risk register and risk management policies for appropriate inclusion of climate change risks
8.	Review and refresh the assessment of the company's climate change and sustainability risk impact on a regular basis
9.	Determine that its management is monitoring and assessing the impact of existing or potential government regulations on the company's business
10.	Report on the organization's climate change and sustainability risks regularly to its board

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