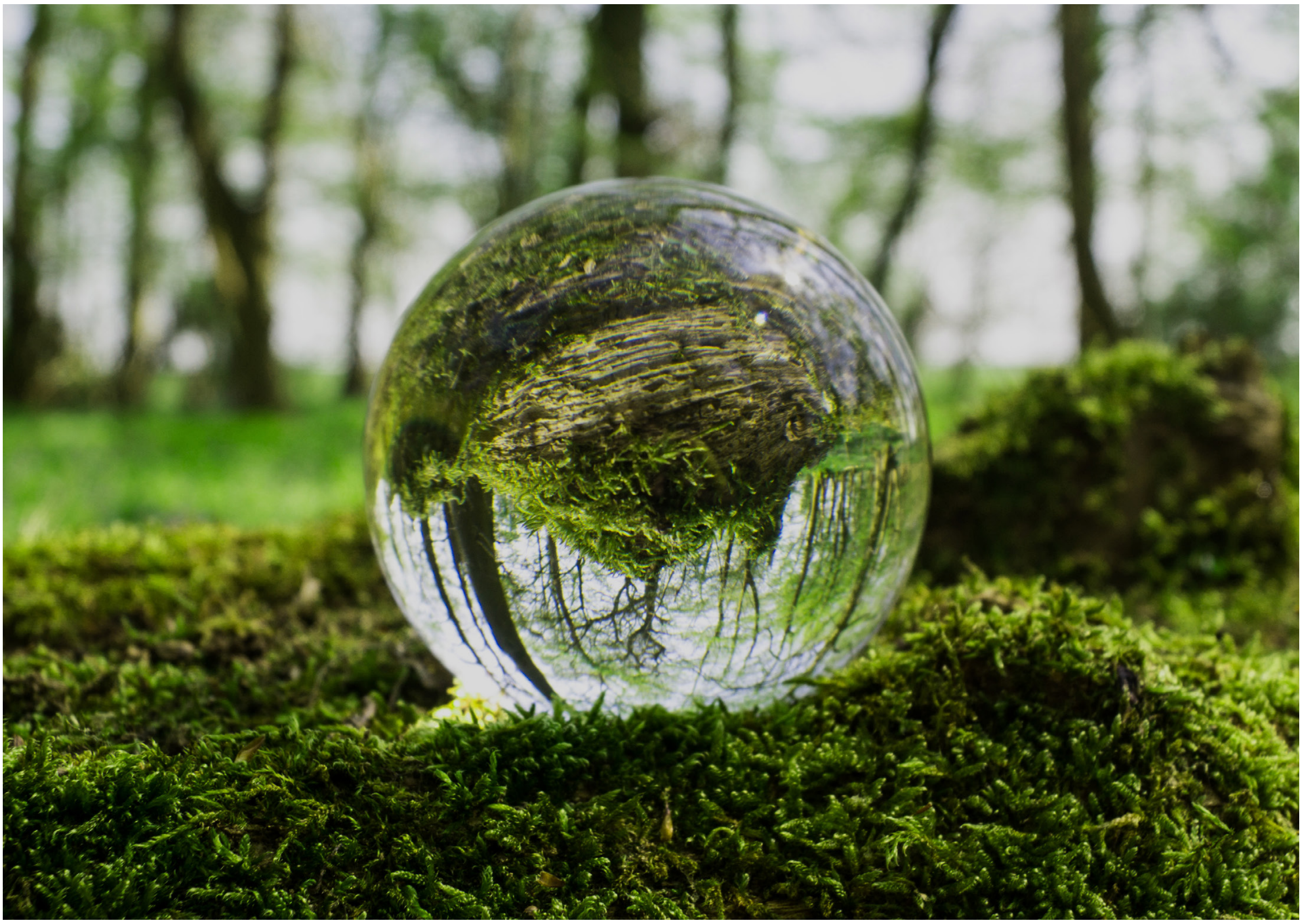


Empowering your company: Elevating your internal controls environment for ESG Success

In today's business environment, stakeholders such as investors and customers are increasingly seeking more information to inform their decision-making processes. The growing interest in sustainable business practices, including decarbonisation and human capital, has led to the development of various environmental, social, and governance (ESG) standards, frameworks, and regulatory reporting requirements all over the world. Recent examples include the Securities and Exchange Commission (SEC) proposed climate-related disclosure rule and the EU's adoption of the Corporate Sustainability Reporting Directive (CSRD). While ESG discussions in board rooms have predominantly focused on the "E" (environmental) aspect, the ESG reporting landscape continues to evolve along with stakeholder expectations. Given the legal requirements and regulatory pressure including increasing Assurance requirements, companies should now focus on deliberate organisation and consider implementing comprehensive mechanisms to effectively address all aspects of ESG, including associated risks and opportunities. It is a crucial aspect for companies to collect complete and accurate data to be able to make informed decision. This topic is especially important since the data collected now, sets the direction for the coming next years.

Drawing from the lessons of compliance with the Sarbanes-Oxley Act of 2002 (SOX), we understand that effective internal controls and robust processes can drive mindset shifts, identify efficiency opportunities, and facilitate transformation throughout an organisation. With the recent release of the Committee of Sponsoring Organisations of the Treadway Commission's (COSO) 2023 interpretive report on internal control over sustainability reporting (ICSR), it is time for companies to turn the page. Companies must expand their focus beyond traditional internal controls over financial reporting (ICFR) and start establishing a control environment where it substantiates the firm's commitment to ESG. Timely integrating scalable ESG-related internal controls into existing frameworks enhances organisations and anticipates stakeholder interests amidst a rapidly transforming ESG landscape.

In this article, we will delve into strategies for aligning your people, processes, and technology to maximise the benefits of your company's ESG strategy.

Focus on Governance

Given evolving standards and requirements, establishing an internal control framework for ESG will likely be a marathon, not a sprint. This journey typically commences with governance. A robust "tone at the top" sets clear expectations and aids companies in shaping the governance framework essential for attaining their sustainable business goals.

You might want to think about establishing a cross-functional working group as your governance structure. This approach can help gather a variety of perspectives and insights, and effectively monitor the setting and achievement of goals throughout the company.

Deloitte's December 2022 Sustainability Action Report findings highlight that while a majority (81%) of executives continue to create new roles and responsibilities to accommodate additional disclosure requirements, it is important that organisations take the appropriate steps to prepare their governance structure.
The group could include representation from functions such as internal audit, board and executive leadership, risk, compliance, sustainability, and finance as well as legal, human resources, strategy, operations, and communications, among others. This kind of framework is better prepared to encourage uniform organisational practices and enhance the alignment of ESG risk and opportunity prioritisation. It's particularly effective in adapting to emerging trends, regulatory demands, and market conditions. After establishing a clear governance structure, the governing body should focus on establishing an implementation roadmap, including:

- Develop a sustainability reporting strategy, including the identification of relevant standards, frameworks, and performance measures;
- align the company's sustainable business objectives with enterprise strategic, operational, reporting, and compliance objectives; and
- monitor progress against the company's sustainability goals and targets.

International standards (e.g. TCFD, GRI, CSRD) and the Swiss Financial Market Supervisory Authority (FINMA) widely require that the governing body takes ownership of the implementation roadmap alongside executive management and reports directly to the board of directors. Setting up a regular communication schedule is beneficial for keeping everyone informed of progress and for identifying and resolving obstacles. Incorporate the role and responsibilities of the governing body as an entity-level control into your existing internal control framework as a way to define authority and enhance internal monitoring.

The road to transformation: Key considerations

Change is inherently challenging, and this transformation is likely to pose significant hurdles. Implementing a robust change management strategy is crucial, alongside garnering full support from all stakeholders, ranging from frontline staff to board members. The sooner a unified vision is communicated and embraced, the clearer roles and responsibilities become. Here are key considerations for your change management plan:

- Board oversight to bolster the ESG-related control framework;
- Transparent communication to set expectations for all parties involved;
- Accessible resources detailing the implementation roadmap, expectations, and key contributors;
- CEO and CFO endorsement underscoring the initiative's significance for top-level accountability;
- Aligning executive compensation with the organisation's ESG strategy.

Focus on People

When incorporating ESG-related internal controls into your control environment, it's crucial to maintain regular and consistent communication across your organisation. Additionally, provide sufficient training to enhance competency among employees and control owners. Adopt a human-centered approach that prioritises inspiring and incentivising your workforce to embrace forthcoming cultural and organisational shifts.

The responsibility over ESG metrics will most likely require the involvement of most – if not all – areas of your company, which means the responsibility typically lies beyond the accounting and finance function.

Regular review and update of internal policies and procedures is therefore essential to align the organisation's expectations and responsibilities. Executive management should provide meaningful support through training and cross-functional development, ensuring employees not only embrace company values but also possess the necessary skills to advance strategic ESG objectives.

Review the workforce and add specialised knowledge and skills to bolster the team and control environment. Additionally, review roles across the organisation to assess for proper segregation of duties. It is not uncommon for personnel to be designated as a first-time control owner or control performer. In these situations, offer specialised training that clearly delineates responsibilities and expectations around the performance of the control. This includes the level of documentation required to be maintained, so exceptions, if any, are identified and corrective actions are effectively taken in a timely manner.

Discuss your ESG vision and progress with internal and external auditors to ensure the company's ESG implementation roadmap aligns with their professional expectations. Evaluating readiness for ESG assurance can cultivate the discipline and internal framework needed to adeptly navigate and mitigate risks.

Focus on Processes

While implementing ESG-related processes and internal controls, organisations should build upon existing frameworks rather than starting from scratch. Leverage on your existing control framework and create synergies.

Below are steps to keep in mind as you start – or continue tailoring and adapting your internal control system to meet your unique sustainable business reporting objectives and stakeholders' growing expectations:

1 Define an ESG reporting scope

Before embarking on your ESG reporting journey, it is crucial to gain a comprehensive understanding of both short-term and long-term reporting requirements that are relevant to your organisation. Additionally, identifying voluntary reporting metrics that can drive enterprise value is essential.

Given the potential impact of various ESG regulations on global companies, it is important to determine which rules and legislations are applicable, identify the qualifying subsidiaries subject to these regulations, and establish a compliance timeline. Currently required only by some standards explicitly, the exercise of the Double Materiality Assessment (DMA) certainly is best practice[1] to complement the scoping exercise and evaluate qualitative and quantitative factors to narrow the focus on what matters to your organisation and where you should spend your time.

This assessment should consider on one hand impacts (actual or potential, positive or negative, short-, medium and long-term time horizons, on people or on the environment) directly linked through operations, products or services and relationships to the company; and on the other hand sustainability risks and opportunities for the company (actual and potential risks or opportunities, impacts on cash flows, development, performance, position, cost of capital or access to finance, over the short-, medium- and long-term time horizon). Incorporate the review of applicable ESG reporting requirements and performance of the ESG materiality assessment as internal controls within your company's existing framework.

2 Understand your process and current control environment

Perform an assessment of your current state of your sustainability control environment, by conducting walkthroughs with company personnel and reviewing existing policies and procedures. Additionally, consider the relevant reporting boundaries to ensure all necessary disclosures are included in the evaluation. Assessing the accuracy and completeness of data necessary for reporting ESG metrics is crucial for ensuring transparency and reliability in sustainability reporting. Therefore, consider the following key considerations: identify relevant systems, evaluate methodologies for data collection and determine how ESG metrics are measured. Prioritise the evaluation of the most critical ESG metrics and apply the insights gained to other areas.

In developing a plan to establish robust ESG-related internal controls, consider leveraging the COSO Internal Control — Integrated Framework (the "COSO Framework"). The COSO Framework remains one of the most widely used—for public and private companies across all industries—for establishing internal controls and for evaluating and maintaining their effectiveness, while enhancing the likelihood of achieving the entity's objectives and adapting to changes in the business and operating environments. On March 30, 2023, COSO released a landmark interpretive report[2] on how the COSO Framework can help companies establish an effective and integrated system of internal control over their material and decision-useful sustainable business information[3].

Integrate ESG risks and opportunities into your company's existing enterprise risk management framework to enhance alignment with business objectives, foster cross-functional collaboration, and improve the assessment of incentives and pressures for fraud.

3 Perform a gap assessment and remediate

After gaining an understanding of your present state sustainability processes, it is important to identify any missing and/or inadequate ESG-related internal controls that fail to fully mitigate associated risks. During this gap assessment consider the consistency of processes and controls across applicable reporting boundaries and their impact on overall disclosure integrity. Analyse the severity of each gap to prioritise remediation efforts effectively. For each gap, assign ownership to drive accountability, establish a timeline, and develop a plan for remediation.

Examples of common gaps may include incomplete or inaccurate listings of facilities, a lack of review for the accuracy and completeness of source data used in the preparation of disclosures, and insufficient controls for identifying and monitoring applicable regulations timely and effectively (e.g., greenhouse gas (GHG) emission-related disclosures). Consider adding controls that validate the completeness of your data, review operational and organisational boundaries, and corroborate the use of applicable regulations through reporting.

An organisation will likely need to create new processes and controls as a result of this assessment; however, you usually don't need to start from scratch. Consider leveraging processes that are already in place for ICFR and enhance existing internal controls accordingly.

4 Monitor

Develop timely a risk-based testing plan and procedures for each ESG-related internal control. Regularly assess design, implementation, and operating effectiveness. At least on an annual basis, reassess whether control activities are implemented at the appropriate operational level (e.g., business unit versus enterprise level), are aligned with the risk assessment outcomes, are sufficiently direct and precise, and whether, internal or external, involved parties have sufficient qualifications and certifications.

Ensure that your internal control environment continues to evolve as new gaps are identified, roles and responsibilities shift and regulatory demands progress. And finally, communicate the results of your assessment to those responsible for governance to provide transparency and enable informed decision-making.

Focus on Technology

The objective of developing, integrating, and prioritising ESG-related internal controls is to deliver complete, accurate, and reliable information to stakeholders. Despite the momentum around ESG, many businesses still encounter significant challenges in accessing and ensuring the integrity of the data necessary to comply with both voluntary and mandatory disclosure requirements.

According to Deloitte's 2022 Sustainability Action Report, more than half of executives (60%) cite data quality or access as their greatest challenge with ESG data. This is because ESG data is often more complex, qualitative, forward-looking, and challenging to quantify than traditional financial data. ESG data may have different reporting boundaries and timelines, may be subject to more estimates and assumption, may originate from systems that do not have the same level of internal control, and often requires involvement from several departments across an enterprise.

Companies should make the decisions on how they want to source, transform, and report sustainability data. These considerations can contribute to an increased reporting burden associated with ESG reporting. Therefore, it is important to incorporate sustainability disclosure considerations into data management policies and procedures.

Often the ESG data-gathering process is highly manual and blocks performance. Consider opportunities to automate and digitise the data-gathering process, including investing in new technologies to tackle current limitations. Before investing in new technologies, it is important to appropriately challenge the inherent limitations of potential technologies to preserve the reliability and integrity of information. Consider what internal controls need to be implemented in order to validate the integrity and reliability of ESG data as it flows through various systems within your network; from source to decision-makers both within and outside the organisation.

Tracking a more sustainable and socially responsible future

The time has come to take action and consider investing in ESG-related internal controls.

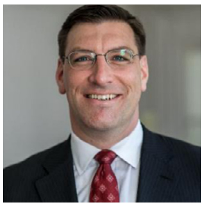
While not all organisations are currently obligated to report on their sustainability practices, stakeholders are increasingly prioritising sustainability factors, leading to the expansion of proposed regulatory reporting requirements. Previously, ESG reporting was often viewed as a competitive advantage to differentiate from other companies. Today, being a responsible business is generally an expectation. Disclosing investor-grade, high-quality, and comparable ESG information is now a legally required minimum standard that is subject to significant external scrutiny, be it formally through external assurance or in the light of litigation and greenwashing risks. A strong internal control environment can help you to ensure completeness and accuracy of ESG reporting, and most likely create value for your company, by demonstrating to stakeholders that your organisation is committed to doing the right thing.

What we can do

- **Establish governance structure** for ESG-related controls by leveraging on company's existing framework.
- **Process documentation** of ESG-related disclosures: Identify synergies with existing internal control framework over financial reporting (ICFR) and determine relevant data sources, systems and process owners.
- **Risk assessment:** Identify potential risks that could impact climate related reporting objectives.
- **Design and implementation of controls:** Evaluate maturity of existing controls to enhance data accuracy and completeness and define internal process controls and general IT controls (GITCs), document methodologies for data collection, measurement and/or estimation.
- **Monitoring** of risk and control matrix: Regularly assess design, implementation and operating effectiveness of controls, remediate control gaps and deficiencies, and implement ongoing process improvements.
- Integrate controls over climate-related disclosure into **enterprise risk management (ERM)** processes and internal audit plans.
- Audit **readiness**: Engage with external assurance provider.

For further discussion, please contact us.

Deloitte has practitioners with experience in ESG reporting and assurance, governance, risk and internal controls across industries to support you in your journey.



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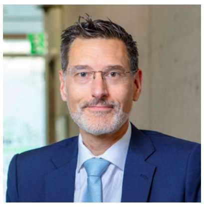

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[1] An double materiality assessment is a process in which companies engage with key stakeholders to understand ESG priorities and align with the business strategy and leading measurement and reporting standards. See Deloitte's May 26, 2022, Heads Up for more information about double materiality assessment considerations.

[2] Shari Helaine Littan et al., Achieving effective internal control over sustainability reporting (ICSR): Building trust and confidence through the COSO Internal Control—Integrated Framework, Committee of Sponsoring Organisations of the Treadway Commission (COSO), 2023.

[3] See Deloitte's April 21, 2023, Heads Up for more information about using the COSO Framework to establish internal control over sustainable business information.

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