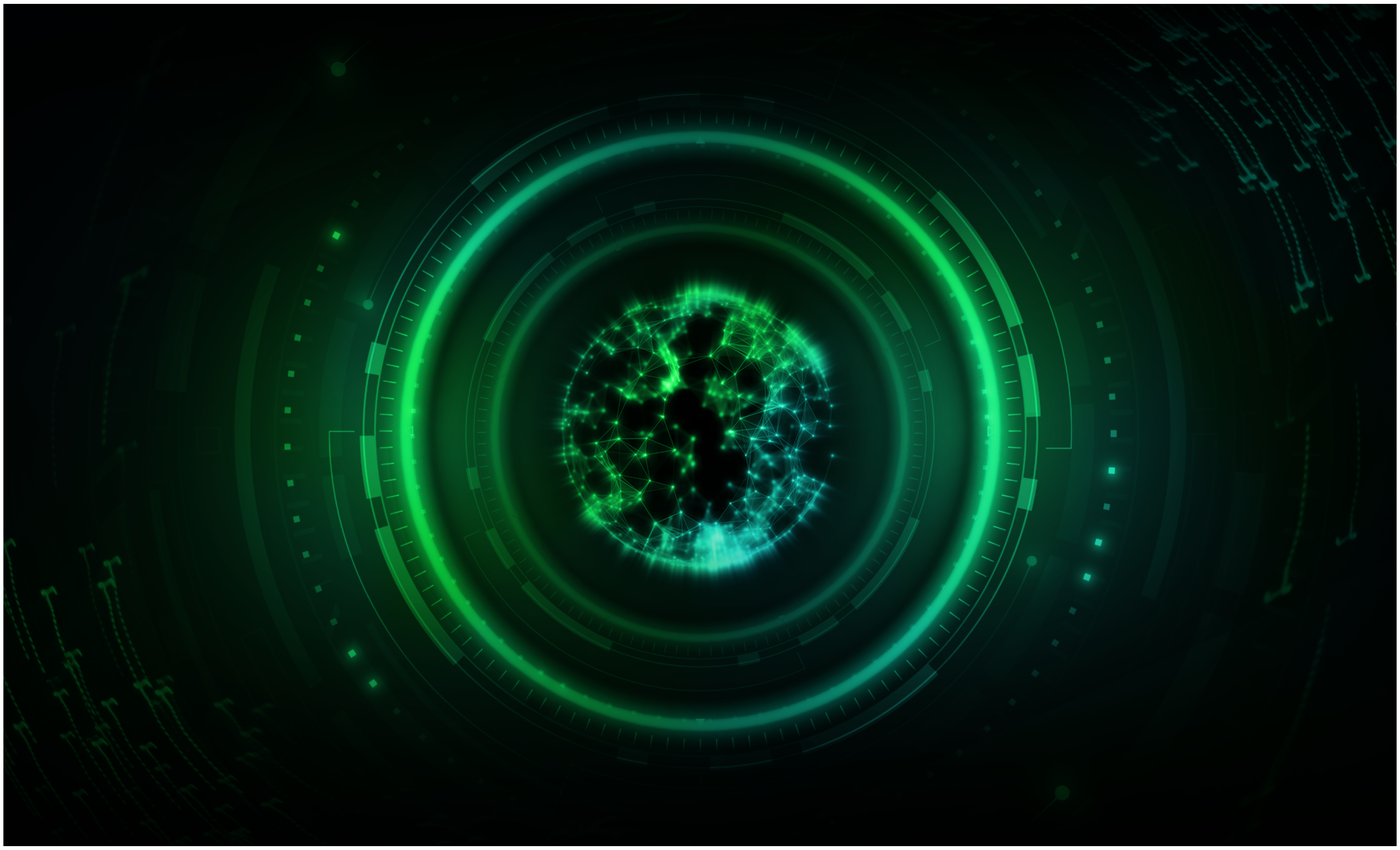


The time is now: Scale your internal controls environment for ESG

In today's market, investors, customers, and other stakeholders are increasingly demanding more information to help drive their decision-making. Increased public interest in decarbonization, human capital, and other sustainable business information is playing a catalytic role in the advancement of various environmental, social, and governance (ESG) standards, frameworks, and proposed regulatory reporting requirements globally. The Securities and Exchange Commission's (SEC) proposed climate-related disclosure rule and the recent adoption of the European Union's Corporate Sustainability Reporting Directive (CSRD) serve as two recent examples of ESG regulatory acceleration. While companies have primarily focused their ESG discussions on the "E," the ESG reporting landscape continues to evolve along with stakeholder expectations. Now is the time for companies to organize intentionally and consider putting in place the right mechanisms to wholistically navigate all pillars of ESG and the corresponding risks and opportunities.

Compliance with the Sarbanes-Oxley Act of 2002 (SOX) taught us that effective internal controls and robust processes can shift mindset across an organization, identify opportunities for efficiency, and drive transformation. Given the current landscape and the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) recent release of the 2023 interpretive report on internal control over sustainability reporting (ICSR), it is time for companies to consider expanding their focus beyond traditional internal controls over financial reporting (ICFR) to a control environment where internal controls also substantiate a company's commitment to ESG. Agility is important. Integration of scalable ESG-related internal controls into your existing framework could accelerate your organization's ability to anticipate stakeholder interests and remain relevant amid a rapidly transforming ESG landscape.

In this article, we will explore how you can prepare your people, processes, and technology in order to capitalize on your company's ESG strategy.

Governance

Implementing an internal control environment around ESG will likely be a journey, not a sprint. And this journey typically begins with governance. A strong "tone at the top" establishes expectations and can help companies form the necessary governance structure to achieve their sustainable business objectives.

Consider forming a cross-functional working group as your governance structure in order to obtain diverse perspectives and insights and oversee the establishment of goals and progress toward those objectives across 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 organizations take the appropriate steps to prepare. 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. Such a structure is more likely to promote consistent organizational practices and increase alignment of ESG risk and opportunity prioritization in the context of emerging trends, regulatory requirements, and market conditions.

Once a clear governance structure is put in place, the governing body should focus on establishing an implementation roadmap, including the following:

- 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.
- Monitor progress against the company's sustainability goals and targets.

The governing body is typically expected to own the implementation road map together with executive management and report directly to the board of directors. Establishing a timely communication cadence is helpful in order to highlight status as well as identify and address roadblocks. Incorporate the function 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.

Focus on people

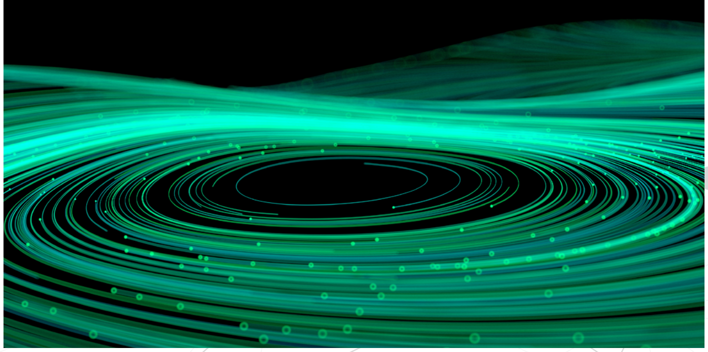
When integrating ESG-related internal controls into your control environment, it is important to deliver consistent and recurring communication throughout your organization, adequate training to improve proper competency across the business and control owners, and a human-centered approach focused on inspiring and incentivizing your people to adapt to the cultural and organizational changes ahead.

Responsibility typically lies beyond the accounting and finance function. Unlike financial reporting, disclosure of ESG metrics will likely require the involvement of most—if not all—areas of an organization. Regularly review and update internal policies and procedures to align the organization on expectations and responsibilities. It is important that executive management provides meaningful support through training and cross-functional development to ensure employees not only share in company values but possess the necessary skills to advance strategic ESG objectives.

What's next?

Change is hard—and this uplift will likely be no easy feat. A proper change management plan is important, as is having the support of all stakeholders involved—from field personnel to the board. The earlier a shared vision is communicated and understood, the clearer responsibilities can become. When considering your change management plan, here are some items to think about:

- **Board oversight** to support the ESG-related control environment
- **Clear communication** articulating the expectations to all those involved
- Readily available **resources** outlining the implementation road map, expectations, and key players
- Emphasis from the **CEO and CFO** reinforcing the importance of the initiative to create **top-down accountability**
- Aligning **executive compensation** to the organization's ESG strategy



Review the workforce and add specialized knowledge or skills, where needed, to support the team and control environment. It is also important to review roles across the organization to assess for proper segregation of duties. It is not uncommon for personnel to be identified as a first-time control owner or control performer. In these situations, specialized training should be provided outlining responsibilities and expectations around the performance of the control, including the level of documentation required to be maintained, so exceptions, if any, are identified and corrective actions are effectively taken in a timely manner.

Finally, don't forget the importance of coordinating with your internal and external auditors. Internal audit or a similar compliance function will likely play a role in validating the effectiveness of ESG-related internal controls. More importantly, internal audit or a similar compliance function often has a proven track record of anticipating risk and helping manage risk broadly across your organization; this perspective is valuable to the development and monitoring of your ESG strategy and reporting. Discuss your ESG vision and progress with internal and external auditors to ensure the company's ESG implementation road map aligns with their professional expectations. Assessing readiness for ESG assurance can help instill the necessary discipline and internal infrastructure to manage risks.

Focus on processes

While an organization will likely need to create new ESG-related processes and internal controls, there is usually no need to start from scratch. Companies should look to leverage and modify processes and controls that already exist as a part of ICFR. Below are steps to consider as you begin—or continue—customizing and adapting your system of internal control to meet your unique sustainable business reporting objectives and stakeholders' growing expectations:

1 Define ESG reporting scope

Before getting started, understand near- and long-term reporting requirements relevant to your organization as well as voluntary reporting metrics that can drive enterprise value. With global companies potentially subject to various ESG regulations, it is important to consider which rules and legislation apply, the qualifying subsidiaries that will be subject to the respective regulations, and the compliance timeline. Perform an ESG materiality assessment,[1] and evaluate qualitative and quantitative factors to narrow the focus on what matters to your organization and where you should spend your time. In performing this assessment, consider past earnings releases and sustainability reports, stakeholder engagement inputs, sustainability goals, key performance indicators, and peer company disclosures as well as your company's risk appetite. 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 current control environment

Perform an assessment on the current state of your sustainability control environment by performing walkthroughs with company personnel and desktop reviews of existing policies and procedures. Consider applicable reporting boundaries to ensure all relevant disclosures are contemplated in the evaluation. Focus your assessment on the accuracy and completeness of data necessary to report ESG metrics (including identification of relevant systems) as well as methodologies for data collection, measurement, and estimation. Prioritize your evaluation of the most critical ESG metrics and apply those insights to other topics.

Examples of qualitative and quantitative factors

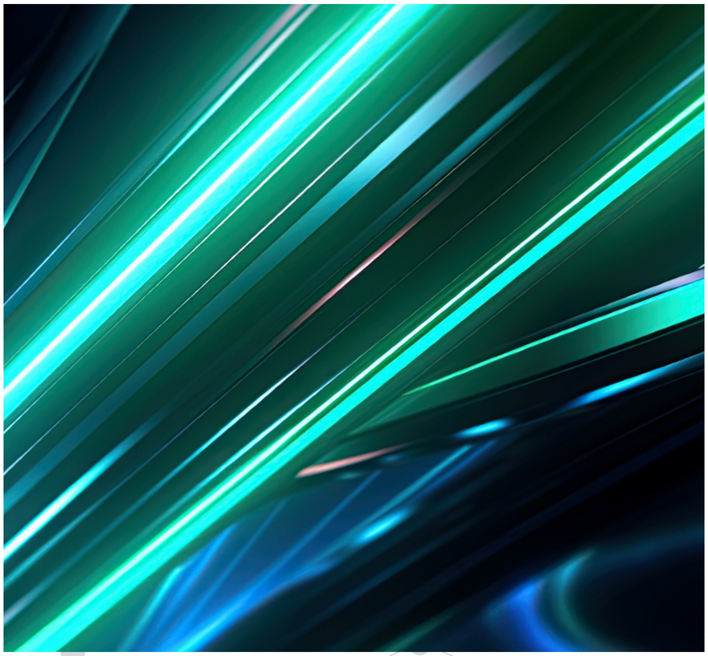
Qualitative	Quantitative
– Previously reported sustainability metrics – Investor and other stakeholder expectations – ESG performance measures internally monitored by the governing body or executive management – Peer benchmarking – Industry-specific standards and expectations – Sustainability metrics tied to green financing – Vendor and customer ESG data requirements	– ESG metrics approaching or exceeding materiality – Business unit activity with significant operations/production – Thresholds outlined within ESG standards, frameworks, and proposed regulatory reporting requirements – Disaggregated operational data

In developing a plan to achieve effective 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]

Incorporate ESG-related risks and opportunities into your company's existing enterprise risk management framework to better align business objective setting, cross-functional collaboration, and assessment of incentives and pressures for fraud.

3 Perform a gap assessment and remediate

After gaining an understanding of your current-state sustainability processes, determine what ESG-related internal controls are missing and/or are not designed to fully mitigate associated risk. When performing this gap assessment, consider to what extent processes and controls are consistent across applicable reporting boundaries and the resulting impact on overall disclosure integrity. Analyze severity to prioritize the control gaps in order to help focus remediation efforts. For each gap, assign ownership to drive accountability, establish a timeline, and develop a road map of remediation.



Examples of common gaps include incomplete or inaccurate listings of facilities, missing review of the accuracy and completeness of source data used in the preparation of disclosures, and controls to identify the applicable regulations adopted, timely and effectively, and continuously monitored for ongoing compliance (i.e., greenhouse gas (GHG) emission-related disclosures). Consider adding controls that validate the completeness of your data, review operational and organizational boundaries, and corroborate the use of applicable regulations through reporting.

An organization will likely need to create new processes and controls as a result of this assessment; however, you usually don't need to go back to the drawing board. Consider leveraging processes that are already in place for ICFR and augment existing internal controls accordingly.

4 Monitor

Develop timely, risk-based test plans and procedures for each ESG-related internal control. Regularly assess design, implementation, and operating effectiveness. At least annually, reassess whether control activities are applied at the right operating level (i.e., business unit versus enterprise level), are aligned with risk assessment outcomes, are sufficiently direct and precise, and whether parties involved—both internal and external to the organization—have sufficient qualifications and certifications. Ensure your internal control environment continues to evolve as new gaps are identified, roles and responsibilities change, and regulatory requirements advance. Communicate results of your assessment with those charged with governance.

Focus on technology

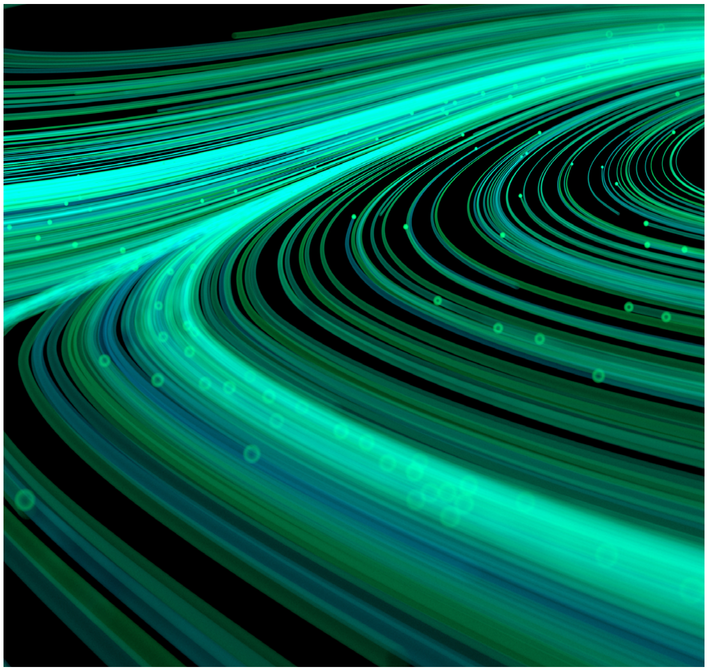
The aim of developing, integrating, and prioritizing ESG-related internal controls is to deliver complete, accurate, and reliable information to stakeholders. Despite all the momentum behind ESG, many businesses today still face significant challenges obtaining access to and ensuring the integrity of data required to comply with 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. Such data may have different reporting boundaries and timelines, may be subject to more estimates and assumptions, may originate from systems that do not have the same level of internal control, and often requires involvement from a variety of departments across an enterprise.

Companies should make the decisions on how they want to source, transform, and report ESG-related data as well as anticipate what other data may be needed in the future as stakeholder expectations continue to evolve. All these factors can increase the reporting burden associated with ESG reporting, which is why it is important to incorporate sustainability disclosure considerations into data management policies and procedures.

For those companies that have already begun developing processes around the gathering and processing of ESG data, it is helpful to ensure the organization has a deep understanding of the end-to-end data flow and the current-state data acquisition strategy. Focus on designing processes that result in consistent, accurate, and complete data sets and promote timely collection and dissemination of data. Proposed regulatory reporting requirements generally require comparative historical information to be presented upon adoption. Therefore, it is important to have the appropriate infrastructure in place to collect ESG data for all periods required for mandatory reporting or all periods desired for voluntary reporting.

Often the ESG data-gathering process is highly manual, which can impede performance. Consider opportunities to automate and digitize the data-gathering process, including investing in new technologies to combat current limitations. Automated information and communication systems can help organizations effectively collect, measure, and present ESG-related information in a manner that is understandable to process owners, relevant to external users, and supportive of effective internal controls, resulting in organizational efficiencies and enhanced decision-making capabilities. Automated controls are also inherently more reliable than manual controls when they are designed appropriately, and there is less opportunity for human error once implemented.

Before deciding to adopt a new technology, 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 of ESG data as it flows through various systems within your network, and from source to decision-makers—both internal and external to the organization. For any new system implementation, ensure identified risks associated with the system are appropriately mitigated by effective data migration or integration controls.



Technologies housing ESG data may not have been historically identified as relevant systems for ICFR. As such, a risk assessment should be performed to identify which systems will need to be brought into scope for further monitoring. In making this determination, management should assess whether the inherent nature of existing processes, including general information technology and interface controls in combination with compensating manual controls (e.g., reconciliation-type controls), effectively mitigate applicable technology risks.

Tracking a more sustainable and socially responsible future

Call for action—the time has come to consider investing in ESG-related internal controls. While not all entities are currently required to report on their sustainability practices, stakeholders continue to place greater emphasis on ESG, causing proposed regulatory reporting requirements to broaden in scope. Previously, ESG reporting was often viewed as a competitive advantage to help companies stand out from the crowd. Today, being a responsible business is generally an expectation, and the disclosure of investor-grade, high-quality, comparable ESG information is often table stakes. Designing a robust internal control environment can help ensure completeness and accuracy of ESG reporting, while also potentially creating enterprise value by demonstrating to stakeholders that your organization is committed to doing the right thing.

For further discussion, please contact us. Deloitte has practitioners with experience in ESG and governance, risks, and controls across industries to help.

Authors

Kajal Shah
Audit & Assurance Partner
Accounting & Reporting Advisory Services
Deloitte & Touche LLP
+1 408 857 6186
kajshah@deloitte.com

Jessica Herbst
Audit & Assurance Partner
Accounting & Reporting Advisory Services
Deloitte & Touche LLP
+ 1 713 982 4936
jeherbst@deloitte.com

Abby Cohen
Audit & Assurance Senior Manager
Accounting & Reporting Advisory Services
Deloitte & Touche LLP
+1 408 704 2466
abcohen@deloitte.com

Carlos Cruz
Audit & Assurance Manager
Accounting & Reporting Advisory Services
Deloitte & Touche LLP
+1 713 982 2543
carlcruz@deloitte.com

Contributors

Robert Kerr
Audit & Assurance Partner
Accounting & Reporting Advisory Services
Deloitte & Touche LLP
+1 404 942 6858
rokerr@deloitte.com

Michael Schor
Partner
Risk and Financial Advisory
Deloitte & Touche LLP
+1 212 436 6208
mschor@deloitte.com

Shelby Greenfield
Senior Manager
Risk and Financial Advisory
Deloitte & Touche LLP
+1 206 716 7681
shegreenfield@deloitte.com

Meadow Rutenbar
Audit & Assurance Senior Manager
ESG & Sustainability Services
Deloitte & Touche LLP
+1 215 282 8944
mrutenbar@deloitte.com

Endnotes

1. An environmental, social, and governance (ESG) 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 ESG materiality 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 Organizations 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.

Accounting Advisory & Transformation Services

The services described herein are illustrative in nature and are intended to demonstrate our experience and capabilities in these areas; however, due to independence restrictions that may apply to audit clients (including affiliates) of Deloitte & Touche LLP, we may be unable to provide certain services based on individual facts and circumstances.

This article contains general information only and Deloitte is not, by means of this article, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

About Deloitte

As used in this document, "Deloitte" means Deloitte & Touche LLP, which provides audit, assurance, and risk and financial advisory services, which provides advisory services. These entities are separate subsidiaries of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2023 Deloitte Development LLC. All rights reserved.