

# Audit Committee *Brief*



## The era of sustainability disclosure

During the past few decades, the primary drivers of business value have shifted significantly. Formerly, capital market performance most closely tracked an organization's tangible assets, but today's markets are more strongly correlated with intangible assets in the form of goodwill or brand equity, which can include research and development, brand, reputation, management of external social and environmental factors, and social license to operate. Many feel that traditional financial metrics may not effectively capture a company's long-term value creation potential, but rather serve as indicators of short-term performance. This shift in value drivers and a broader recognition of the importance of environmental, social, and governance (ESG) performance have been accelerated by market forces demanding greater transparency by companies. In addition, there has been an increase in initiatives to promote and, in some instances, enforce more structured ESG reporting.

Sustainability has also made it to the top of shareholders' agendas. In 2013, the number of social and environmental policy proposals filed has grown to comprise the second largest proportion of shareholder-sponsored proposals (after proposals focusing on corporate governance). Many companies are responding to the proposals by publishing sustainability reports and shedding more light on their approach to social and environmental issues raised by shareholders.



In a recent [survey](#), 60 percent of CFOs at large global enterprises, with average annual revenue of \$17 billion, indicated that sustainability challenges will change financial reporting and the associated auditing activities.<sup>1</sup> The financial and nonfinancial reporting landscape is changing rapidly, and it is increasingly important for audit committees and boards of directors to understand ESG disclosures that link resource efficiency, business model resilience, innovation capacity, customer satisfaction, human resources, reputation and brand strength, and social license to operate with the drive to create value and long-term business success. In line with increasing demands for transparency, the landscape of sustainability standard-setting and disclosure initiatives continues to evolve through efforts such as the [Global Reporting Initiative](#) (GRI) and the [Sustainability Accounting Standards Board](#), which seek to achieve greater transparency and comparability for nonfinancial reporting. Additionally, the broader [International Integrated Reporting Council](#) initiative is seeking to advance disclosure focusing on the interrelationships of financial and nonfinancial information. More information about these initiatives can be found on their respective websites.

In short, sustainability reporting and disclosure are here to stay and are becoming an essential area of focus for audit committees in their leadership oversight role. The audit committee should understand how to promote confidence in the credibility and reliability of the sustainability information disclosed to the market. This confidence can be achieved through considering internal and external assurance for sustainability disclosures.

### The scope of sustainability

ESG-related risks cover a variety of areas, and the relative prominence of the risks will vary based on industry and an organization's specific circumstances. An article in the [January 31, 2013](#), issue of *Deloitte Review*, titled *Finding the Value in Environmental, Social, and Governance Performance*, highlights the long-term value of ESG management and discusses the following risks:

#### **Direct operational risks**

- Environmental issues such as carbon emissions, water pollution, and associated penalties and fines
- Accidents, spills, and equipment failure
- Social issues such as employee strikes, wage concerns, and health and safety matters

#### **Supply chain risks**

- Ingredients and the use of natural resources, such as palm oil, old-growth forest, and water
- Weather catastrophes
- Child labor, conflict minerals, and other human rights issues

#### **Product risks**

- Ingredients such as toxic chemicals
- Product performance, recalls, and boycotts

<sup>1</sup> Eric Hespenheide and Dinah A. Koehler, [Disclosure of Long-Term Business Value: What Matters?](#) Deloitte Development LLC, 2012.

## Benefits from improved ESG reporting

To make sustainability reporting business-critical, companies should consider adopting a robust methodology for determining ESG materiality. Deloitte's report, [\*Going from Good to Great: Ways to Make Your Sustainability Report Business-Critical\*](#), discusses ESG materiality considerations, as well as benefits that may be gained from improved ESG reporting, which include the following:

- Attracting investment in your company because the focus is on business-relevant information
- Directing how your company allocates capital and formulates its core business strategy
- Building and strengthening your company's reputation and proposition
- Addressing stakeholder concerns credibly



## What is sustainability reporting and why is it important for audit committees?

Sustainability reporting, as defined by the GRI, is the practice of measuring, disclosing, and being accountable for organizational performance while working toward the goal of sustainable development. A sustainability report can provide a balanced and reasonable representation of the sustainability performance of the reporting organization, including both positive and negative contributions.<sup>2</sup>

Sustainability matters can be wide ranging and often have a significant impact on organizations, affecting the way they operate and the products and services they provide. Customers, suppliers, employees, and investors have long considered sustainability performance disclosure to be a key criterion in determining whether they wish to be associated with an organization. As stewards responsible for helping govern the enterprise by identifying and mitigating risk to attain long-term value creation, audit committees should consider making sustainability reporting a priority on their agendas.

## Sustainability reporting and assurance

The risks associated with sustainability encompass a variety of environmental and social concerns, including fair-labor practices and human rights. Risks such as noncompliance with environmental regulations and employee injury—collectively known as environmental, health, and safety matters—generally attract the most attention from management. Noncompliance in this area can lead to serious injury or loss of life, as well as negative media attention and sizable fines. Given their importance, these risks are often listed in companies' periodic SEC filings, such as Form 10-K. A closer look at the types of risks companies face illustrates the ubiquitous nature of sustainability across the economic, environmental, and social spheres.

Different functions in an organization may own certain aspects of the nonfinancial data, and the quality of this information may vary, particularly if aggregated among various subsidiaries; internal assurance can help validate sustainability data before it is reported to stakeholders. Mature organizations may elect to obtain external assurance for their sustainability data, but conducting an internal audit of the reported information would be a beneficial measure. Similar to the financial statement audit, many companies have their sustainability report assured by a third party. Stakeholders such as regulators, investors, employees, and insurers are increasingly relying on such assurance to assess the quality and reliability of these reports.

<sup>2</sup> *Sustainability Reporting Guidelines, Version 4. 2013 GRI.*

## Conflict minerals

Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act calls for the SEC to adopt regulations requiring conflict minerals disclosures. Such disclosures fall under the umbrella of ESG disclosure due to the extreme violence and human rights violations associated with the commerce of four types of minerals—tin, tantalum, tungsten, and gold—coming from the Democratic Republic of Congo and adjoining countries.

The SEC-enacted rule requires SEC registrants to follow a three-step process for evaluating the use of conflict minerals and to file a new form (Form SD) commencing with the calendar year ending December 31, 2013. This form must be filed annually by May 31 if the registrant determines that such minerals are necessary to the functionality or production of a product it manufactures. In certain circumstances, registrants are required to include a conflict minerals report and to have an independent private-sector audit performed. Deloitte's [September 11, 2012](#), issue of *Heads Up*, titled *As Good as Gold? SEC Issues Final Rule on Conflict Minerals*, contains further information on conflict minerals disclosures.



## Conclusion

ESG information is increasingly important to investors and other stakeholders who are evaluating a company's performance and potential value creation. It is important to recognize the benefits from improved ESG disclosure, as well as the questions that audit committees should consider when initiating the journey to sustainability reporting.

While traditional financial metrics continue to be the primary focus for senior executives and audit committees in assessing performance, as the demand for disclosure and reporting of sustainability performance escalates, audit committees and boards of directors will benefit from focusing on both financial and nonfinancial information as important elements in assessing and communicating the organization's health.

## Questions for audit committees to consider

- Do we understand the risks and opportunities that arise from the ESG impacts of the company's business strategy? Do these impacts represent a threat to brand, reputation, and social license to operate, and how is this reflected in the company's public disclosures?
- Do we understand the risks and opportunities associated with the ESG performance of our suppliers in the value chain?
- Does the company have a sustainability reporting strategy that is supported by suitable policies? Has this strategy been reviewed and approved by the board?
- Do we understand the company's sustainability reporting and disclosure process and underlying drivers, including the consideration of risks and opportunities related to increased transparency?
- Has sustainability reporting been aligned with the overall business reporting process?
- Do we receive adequate educational and briefing information from senior management regarding sustainability issues facing the organization and related disclosure considerations?
- Do we have an appropriate governance structure in place to effectively oversee the management of sustainability reporting and disclosure issues?
- What role does internal and external assurance play in promoting the credibility and reliability of our sustainability disclosures?



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## Additional resources



[Disclosure of Long-Term Business Value: What Matters?](#)



[Finding the Value in Environmental, Social, and Governance Performance](#)



[Going from Good to Great: Ways to Make Your Sustainability Report Business-Critical](#)



[As Good as Gold? SEC Issues Final Rule on Conflict Minerals](#)

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