SUMMARY OF EFFECTIVE INTERNAL CONTROL OVER SUSTAINABILITY REPORTING (ICSR)

Government and ESG
Sub – Group
UAE IAA

Contents

BACKGROUND:

Sustainability is multidisciplinary. The professionals needed to bring sustainability to an organization have different backgrounds and areas of expertise. While some have significant familiarity with internal control systems, they may lack familiarity with sustainability. Others may have expertise in public policy or corporate social responsibility but lack the background in developing sophisticated governance and reporting systems. Further, sustainability means the involvement of participants from a range of other areas, such as legal, human resources, facilities, operations, and investor relations, all of whom may lack understanding of COSO and reporting systems.

The goal of this publication is to provide a valuable means for facilitating this interdisciplinary cooperation. As noted throughout, Internal Control-Integrated Framework **(ICIF)** is holistic. While it indeed supports the development and execution of ICFR, it explains "how to" support the operationalizing of sustainability throughout an organization.

As a result, many readers will find this background section helpful in providing context and understanding the Framework.

EXECUTIVE SUMMARY:

Effective internal controls are good for business. Internal controls have value beyond compliance and external financial reporting. Effective internal controls can help an organization articulate its purpose, set its objectives and strategy, and grow on a sustained basis with confidence and integrity in all types of information.

The Committee of Sponsoring Organizations of the Treadway Commission - Internal Control Integrated Framework (**COSO - ICIF**):

- Enables organizations to develop and maintain systems of internal control that can enhance the likelihood of achieving the organization's objectives and adapt to changes in the business and operating environments effectively and efficiently.
- Continues to emphasize the importance of management judgment in designing, implementing, and conducting internal control, and in assessing the effectiveness of a system of internal control.
- The Framework has been enhanced by expanding the financial reporting category of objectives to include other important forms of reporting, such as nonfinancial and internal reporting which is inclusive of sustainable business information "referred to as **ESG**".

ESG is accelerating in importance as organizations seek to improve their enterprise performance and relationships with stakeholders, both local and global. Given the increasing complexities and challenges of doing business in the world today, organizations are doing so in order to generate sustained value—ethically and responsibly—over the longer term. Companies are improving their performance management systems to have reliable data for decision making.

Meanwhile, investors and rating agencies around the world are increasingly seeking and relying on sustainability performance data. So, there is a need among all stakeholder groups for effective controls and oversight so that this information is high-quality and fit for purpose: decision making in this changing world.

With sustainability and ESG reporting now having become a top area of focus for CEOs, senior management, boards, investors, regulators, customers, and other stakeholders, we find that many more companies are now in various stages of implementing controls and governance processes over the collection, review, and reporting of sustainability information, including creating multifunctional teams that bring together a company's sustainability, finance and accounting, risk management, legal, and internal audit professionals.

DEFINITIONS:

Sustainability: meeting the needs of the present without compromising the ability of future generations to meet their own needs.

Sustainable business: the activities and transactions that an organization conducts to achieve long-term survival as a going concern and concurrently deliver value that meets the expectations of all stakeholders that contribute resources for the organization to achieve its objectives. Following from this, sustainable business information and sustainable business reporting mean the data or information that reflects an organization's sustainable business activities and transactions, and sustainable business management refers to the means by which an organization directs and oversees its sustainable business activities and reporting.

ESG: an acronym for environmental, social, and governance. Often, this term is used synonymously or as a shorthand for sustainability or sustainable business to refer to the internal and external information value chain. More narrowly and within, this term is used generally to describe the constructs of external disclosure of categories of sustainable business information to investors and other stakeholders.

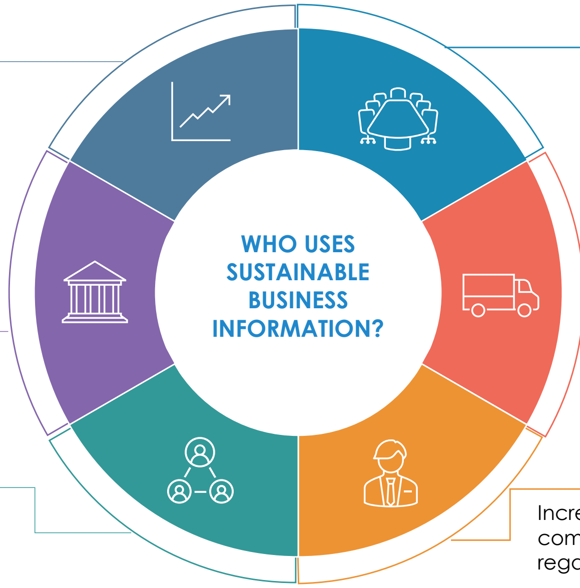
USERS OF SUSTAINABLE BUSINESS INFORMATION:

Capital markets

- Long-term investors
- Institutional investor
- Rating companies

BOD & Senior Management

Important users of sustainable business information for internal decision-making purposes



Public Policy Entities

ESG reporting is moving from voluntary to mandatory Governments Regulators& Nongovernmental org.

Supplier

Responding to their own stakeholders as they commit to ESG practices

Customers

- Commercial buyers
- End users

Employees

Increasingly interested in their companies' policies and practices regarding major ESG issues

ESG: TYPES OF SUSTAINABLE BUSINESS INFORMATIO:

Environmental

- Biodiversity
- Climate change
- Deforestation
- Energy use
- Extreme weather
- GHG emissions
- Landfill
- Oceans
- Recycling
- Soil health
- Transportation
- Water management

Social

- Community relations
- Data privacy
- Diversity, equity, and inclusion
- Education and training
- Employee compensation & benefits
- Employee engagement
- Health and safety, product use
- Human rights
- Modern slavery
- Opportunities for meaningful work
- Union rights

Governance

- Anti-bribery and anti-corruption
- Anti-fraud
- Corporate board, structure
- Data protection
- Executive compensation policies
- Regulatory compliance
- Shareholder rights and engagement
- Transparency, disclosure
- Whistleblower policy

What Is COSO?

COSO refers to [the Committee of Sponsoring Organizations of the Treadway Commission](), which is made up of five global accountancy and auditing organizations:

- American Accounting Association (AAA).
- Association of International Certified Public Accountants (AICPA).
- Financial Executives International (FEI).
- Institute of Management Accountants; and
- The Institute of Internal Auditors (IIA).

ACHIEVING EFFECTIVE INTERNAL CONTROL OVER SUSTAINABILITY REPORTING (ICSR):

BENEFITS OF ICSR:

An effective system of internal control over sustainable business activities and reporting can result in a variety of benefits, including:

- Alignment of an organization's employees, partners, and stakeholders with its commitment to purpose and articulated objectives.
- Enhanced data quality, utility, comparability, and reliability.
- Strengthened ability to support operations & compliance objectives.
- Better-informed decision making by internal management, external investors, and other stakeholders.
- Enhanced understanding of risks and the ability to mitigate them.
- Greater overall market efficiency.
- Increased access to and lowered cost of capital

CONVENTIONAL FINANCIAL REPORTING Vs SUSTAINABLE BUSINESS INFORMATION:

- **Control vs. influence:**

  Financial accounting principles define a "consolidated entity" and detail how to account for minority investees. Sustainability reporting may be based on different concepts of "control" or "influence".

- **Quantitative vs. qualitative:** Sustainability information is inherently more qualitative than traditional financial reporting.
- **Historical vs. forward-looking:** Sustainability information can be more forward-looking and long-term than financial information.

BUILDING INTERNAL CONTROL OVER SUSTAINABILITY REPORTING (ICSR)

COMPONENT 1: Control Environment

1. Demonstrates commitment to integrity and ethical values.

Some organizations demonstrate a commitment to integrity and ethical values by making commitments to sustainability as part of their organizational purpose. Also, commitments to act sustainably can be critical for an organization's reputation and survival.

2. Exercises board of directors' oversight responsibilities

- The board of directors has various committees that oversee different aspects of sustainability activities. An organization may have an audit committee and/or a separate committee, like a "**sustainability committee**", that oversees sustainability activities.

- An organization may enhance audit committee oversight role by revising audit committee charter to include oversight of sustainability information, conducting sustainable business educational sessions, overseeing the internal audit function, reviewing external ESG reports before issuance, etc.

3. **Establishes structures, authority, and responsibilities.**

- Management establishes, with board oversight, organizational structures that will facilitate the organization achieving its sustainable business objectives.
- An organization may create a cross-disciplinary group to promote sustainable business management.
- Some organizations are creating a new functional role, "**sustainability CFO**" or "**ESG controller**," to oversee sustainable business objectives and produce external ESG reporting.

4. **Demonstrates commitment to competent human resources.**

An organization acquires talent to meet sustainable business objectives by promoting synergistic innovation, seizing opportunities, and implementing strategies rooted in sustainable business management.

5. **Enforces accountability.**

- To meet its sustainable business objectives, an organization needs to prioritize organizational commitment by educating employees on the importance of data in meeting sustainable business objectives and other objectives. At the same time, management should consider the ramifications of excessive pressure to achieve targets.
- Research reveals that incentive compensation tied to sustainable business performance has remained fairly limited, but attention is growing

COMPONENT 2: Risk Assessment

6. **Specifies suitable objectives.**

- An organization's sustainable business objectives follow from its commitment to integrity and ethical values and are integrally linked to its operations objectives, external financial reporting objectives, external nonfinancial reporting objectives, internal reporting objectives, and compliance objectives.
- An organization can look to organizations in a similar industry or with a similar business model to set sustainable business objectives.

7. **Identifies and analyzes risks to meeting sustainable business objectives.**

- An organization identifies risks to the achievement of its sustainable business objectives.
- Immature processes and systems can increase the risks by providing unreliable or misstated information needed for decision making.
- An organization should identify risks and opportunities.
- One of the key challenges is that sustainable business information is often based on estimations and expectations.
- Sustainable business management and reporting are dependent on the availability and quality of third-party information. This reliance is a key concern, as an organization may provide **unreliable information** to its customers.

8. **Assesses fraud risk.**

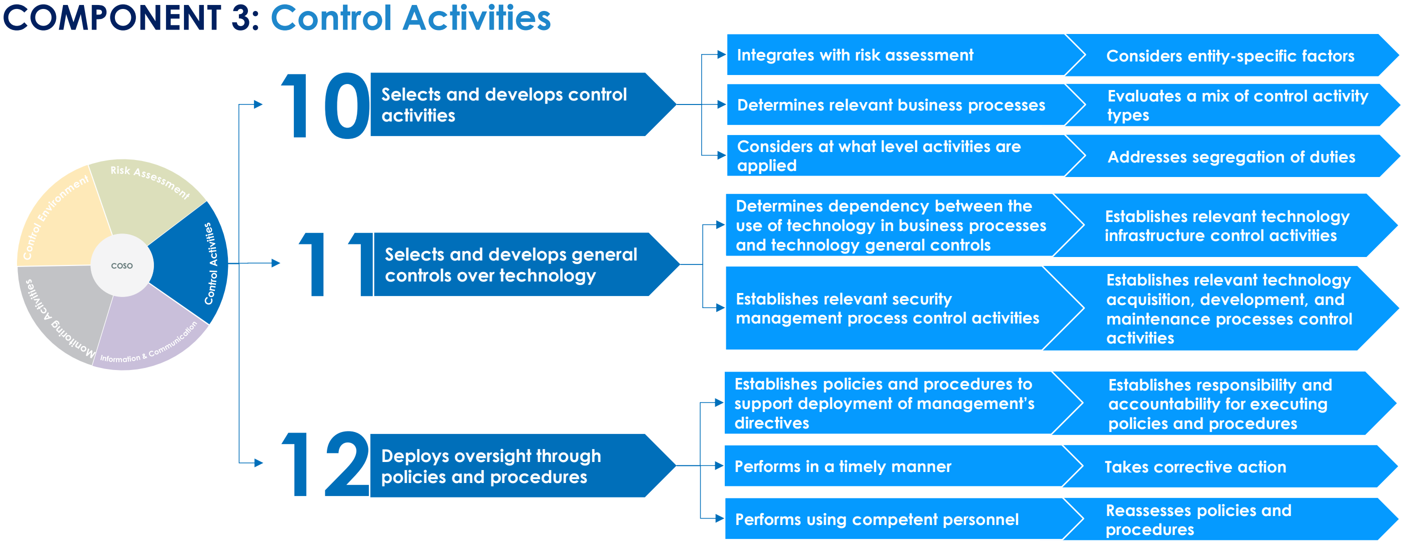
- An organization considers the risk that actors will engage in fraudulent activities such as intentional misstatements or misappropriation of valuable resources.
- Unidentified risks and limited resources to satisfy sustainable business objectives contribute to pressures and opportunities for fraud.
- The desire to meet expectations can encourage malfeasance and incomplete or inaccurate reporting to stakeholders.
- Employees may view sustainability as trivial rather than an integral part of achieving an organization's objectives.
- Green lending is a misstatement; incentives for financial institutions to obtian lending arrangements based on ESG metrics such as "green bonds," "ESG-linked bonds," or "GHG-reduction bonds".
- Internal audit must consider the probability of significant errors and fraud when developing engagement objectives.

9. **Identifies and analyzes significant changes and emerging trends.**

- An organization performs operational assessments of its sustainable business efforts and evaluates them against the best or leading practices to uncover sustainable business opportunities.

- Regulatory mandates for sustainable business information are accelerating. Organizations must keep up with regulatory movement and mandates and may rely on their legal and policy professionals to deliver timely information about these changing requirements.
- Over time, sustainability has gained growing recognition. As these issues mature, new demands for transparency may arise that result in voluntary reporting or mandatory disclosure rules.
- Changing internal dynamics. Often, drivers for movement toward sustainable business activities come from within an organization.

COMPONENT 3: Control Activities



10. Selects and develops control activities.

- An organization needs to design and implement control activities around prioritized sustainable business activities and respond to identified risks by:
  - Assigning responsibilities.
  - Communicating duties to employees (and outside actors) with clarity and adequate background information.
  - Providing knowledge-sharing opportunities and training.
  - Leveraging existing technology.
  - Working with internal audit to reevaluate and respond to risks.

11. Selects and develops general controls over technology.

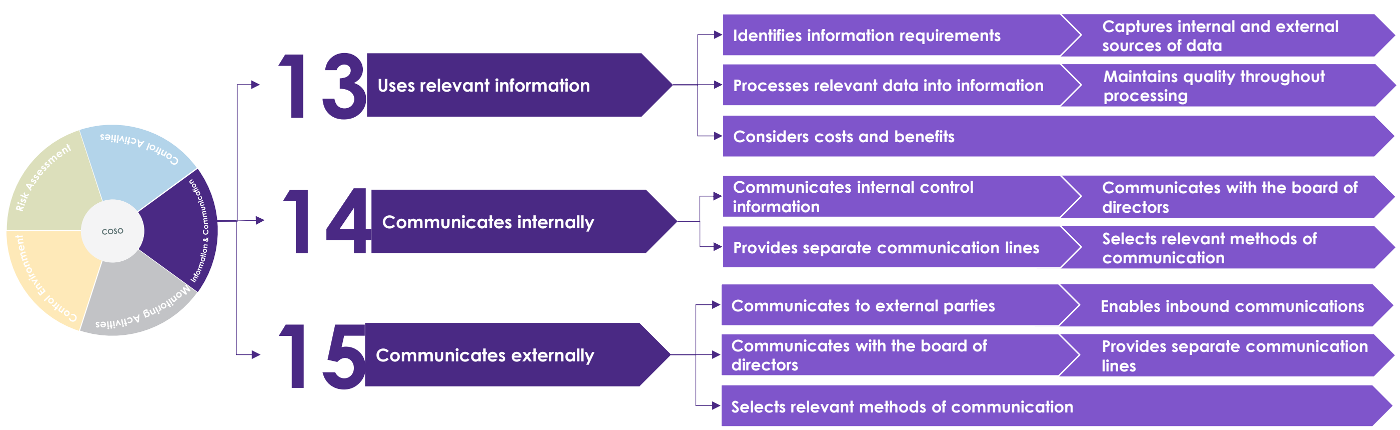
- Defining information technology general controls (ITGC) provides additional insight into control activities over IT.
- One of the most significant concerns is the lack of sophisticated technology systems for sustainable business compared to the infrastructure available for financial reporting.

12. Deploys oversight through policies and procedures.

- An orgaization sets policies and procedures governing sustainable business activities.

- **Structured and unstructured data**; excessive reliance on spreadsheets, outside systems of control and oversight. Accordingly, manual intervention by skilled professionals is required to ensure that the output of one system is reprocessed in the necessary format for submission to the next system.
- Outsourcing operations does not remove accountability from the organization for the completeness, accuracy, and reliability of the data
- Sustainable business reporting team may have its own timeline that is driven by other needs, such as personnel availability, data availability, and requests from rating agencies.
- The internal audit team plays a key role in supplier assessment in accordance with an organization's set policies.

COMPONENT 4: Information and Communication



13. Uses relevant information.

- The governance of sustainable business information and ESG reporting relies on the competencies of professionals in finance, IT, and internal audit to help ensure that organizational decisions are based on information that is **valid, reliable, and relevant**.
- Balancing financial and operational information in business decision making around sustainability to be more reliable.

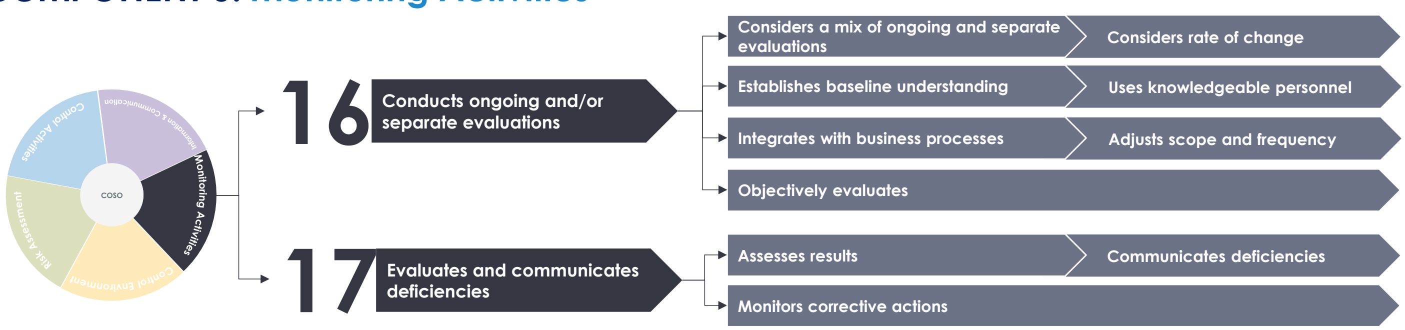
14. Communicates internally.

- An organization creates means to communicate sustainability objectives and performance. This communication facilitates the understanding of all actors regarding their responsibilities for meeting the organization's sustainable business objectives.
- Internal communication controls can achieve sustainable business objectives.

15. Communicates externally.

- **ESG** disclosure processes may overlap with financial reporting requirements, such as annual reports issued by independent accounting firms.
- Determining auditors' responsibilities for ESG disclosures can be complex and depends on applicable laws and whether the auditor has been engaged to provide assurance on specific ESG-related disclosures.
- **ESG** issuer must comply with the law that prohibits misrepresentation or fraudulent disclosures.
- An organization maintains a **whistleblower** program on ESG that allows for the confidential reporting of a public company's activities that indicate fraud.
- An organization considers the influence of impact investors in directing capital to enterprises that demonstrate commitment and performance associated with specific sustainability topics. Appropriate controls can help organizations prioritize these requests and evaluate whether they have accurate, reliable data that is truthful and responsive.

COMPONENT 5: Monitoring Activities



16. Conducts ongoing and/or separate evaluations.

- An organization benefits from engaging competent professionals to assess its sustainability performance processes and outcomes.
- An important responsibility of the internal audit function is to assess and monitor the performance of an organization's controls over financial and sustainability reporting.
- Internal audit professionals have the experience and skill sets that can be redirected to improve controls by collaborating with operational teams.
- An external auditor can communicate in writing, to management and the audit committee material weaknesses identified during the audit.

- External providers who provide external assessments of sustainable business activities may have significant expertise in relevant areas such as GHG emissions, energy, water usage, human resources policies, etc.…

17. **Evaluates and communicates deficiencies.**

In many ways, sustainable business reporting is still subject to evolution and innovation. As a result, it will be a process of continuous improvement.

THE ROLE OF INTERNAL AUDIT:

- As trusted advisors, effective internal audit function provides independent assurance, and, with the right competencies, are related to internal control over sustainability reporting (**ICSR)**, sustainable business risk management, reporting, and related regulatory compliance.
- Advisory efforts to help management design, implement, and improve a broader range of controls related to sustainable business objectives.
- Modernizing internal audit programs to cover sustainable business processes. ESG should become an important aspect of internal audit risk assessments, internal audit planning, and potentially engagements.
- An important responsibility of the internal audit function is to assess and monitor the performance of an organization's controls. This monitoring function applies to (**ICSR)** as well as internal control over financial reporting (**ICFR)**. It extends to any risks that could affect the organization's ability to achieve sustainable business objectives.
- Internal auditors must consider the probability of significant errors and fraud in developing engagement objectives and incorporate procedures for considering, preventing, and detecting fraud not only relating to financial reporting but also to satisfying sustainable business objectives.

TOP 10 TAKEAWAYS:

1. Be committed to ensuring your organization has effective internal control over sustainability-related matters, including operations, compliance, and various types of reporting (external, internal, nonfinancial, and compliance).
2. Ensure that effective internal control over key sustainability activities and reporting "**17 Principles**" are present and functioning as intended.
3. Work with others to determine the best organizational structures, roles, and responsibilities to create the desired results, achieve appropriate internal and external efficiencies, and achieve effective internal control. The Three Lines Model
4. Educating yourself on new topics like sustainability is critical. Take advantage of seminars, new publications, and programs. Collaborate& learn from sustainability professionals, both those inside your organization & outside consultants.
5. Take advantage of other relevant COSO materials on subjects such as ERM and ESG, and others.
6. Internal assurance and confidence in sustainability reporting need to exist before external assurance. Take advantage of your internal audit function in this regard to provide objective assurance & other advice.
7. ESG reporting, both internal and external, is not an "annual and manual" activity. Help make it automated, efficient, and continuous.
8. This is a fast-moving area, and there is bound to be lots of change over the next several years. So, monitoring activities are key in terms of evaluating progress and knowing when to make corrections and enhancements.
9. COSO is not just for large, private-sector publicly listed companies. All organizations, including privately owned, not-for-profit, and public-sector entities need effective internal controls to meet their objectives, manage risk, evolve, and succeed in all areas of their business and activities.
10. Form a cross-functional team consisting of experts in sustainable business (such as corporate social responsibility, integrated reporting, legal, public relations, and human resources) and in internal controls and reporting (finance and accounting). Remember, good internal controls are good for business and apply well beyond compliance and mandatory external disclosures.

RESOURCES:

https://www.coso.org/Shared%20Documents/COSO-ICSR-Report.pdf

https://www.coso.org/sitepages/internal-control.aspx?web=1

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