Katherine Kinkela

10 Environmental, Social and Governance objectives and disclosures (ESG) and enterprise risk

10.1 Introduction

Environmental, Social and Governance (ESG) objectives and disclosures have gained importance in strategic planning and external communications for organizations. Because ESG goals are connected to operational processes, the structure, and metrics for measuring success for ESG initiatives includes selecting appropriate financial and nonfinancial information. ESG related disclosures must balance the need for transparency to external stakeholders with social, political and compliance risks. Environmental, Social and Governance (ESG) disclosures are reports detailing the steps that the organization has taken to meet sustainability goals. ESG disclosures demonstrate the success or failure to meet specific social goals and objectives related to sustainability (Herz, et al., 2017).

One challenge on creating ESG disclosures is that the definition of sustainability is broad:

> Yet "sustainability" has many – and often confusing or conflicting – definitions. Is it sustainability of the enterprise, thereby impacting reputation and "license to operate"? Is it about specific sustainability measures like climate control or deployment of human capital? Does it capture ESG measures? Is it all of the above? (Herz et al., 2017)

Over the past 5 years, global authorities and investors have demanded greater accountability of an organization's leadership to specific social governance goals incorporated into the strategic plan of an organization (Faris, et al., 2013).

> For many organizations, sustainability has evolved from a "feel good" exercise to a strategic imperative that focuses on economic, environmental, and social risks and opportunities which, left unattended, can potentially threaten the long-term success of strategies and the viability of business models. They understand that sustainability is not one function's domain, but a responsibility that the entire enterprise needs to own. This new perspective has raised the visibility of sustainability within the organization and prompted more meaningful discussions at the senior executive and board levels. Sustainability is no longer seen solely as a way of cutting costs or gaining efficiencies. It also can be used as a vehicle to achieve competitive advantage and growth through the positioning of products, services and brands that appeal to the organization's stakeholders. (Faris et al., 2013se)

Thus, ESG programs within firms are essential parts of strategy of the organization as a whole in the contemporary environment, and therefore ESG disclosures have moved from optional positive news flashes to disclosures of critical operational elements within the organization. In addition, as ESG operations have become more

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material within organizations, stakeholders want more disclosure of the objectives and performance of ESG related programs. Most recently, the Securities and Exchange Commission has moved towards ESG requiring disclosures in the annual filings for investment funds. (SEC Press Release May 25, 2022)

Some ESG type disclosures have been mandated by the global community and have a specific required format for compliance, however most ESG disclosures lack a set required format and in general the disclosures are a response to outside community and investors asking organizations to be accountable for social goals. "Sustainability performance data, combined with financial data, is important for the organization to manage and to (voluntarily) communicate its value-creation capacity and capability to global stakeholders" (Herz et al., 2017).

Identification of risk is a critical component of both the developing ESG objectives and the decisions on the timing and nature of ESG disclosures because the success of the strategy relies on an accurate risk assessment. Reporting on the ESG initiatives also has risk. The scope of the ESG disclosures vary and the approach to auditing these ESG disclosures is in the developmental stage. (AICPA Consideration of ESG 2021) Guidance as to the preparation of ESG disclosures from professional and regulatory organizations is developing rapidly in recent times and greater expectations of solid information disclosure are evolving. (FASB Staff Educational Paper 2021)

This chapter will examine how both for profit and not for profit organizations make external disclosures of Global, Criminal Justice, Social and Political Risks in the context of ESG disclosures. Disclosures of any type of risk to an organization present the danger that organizational secrets and strategies are revealed to the public and competitors. Disclosures of assessed risk may also be used in later litigation against an organization. Because of the potential downside to external disclosure of risk, organizations were reluctant to provide information on internal risk assessments unless they were required to disclose information in specific required financial and other legal compliance disclosures. The ESG disclosure requires an organization to balance the need for public transparency with the need to keep strategic risk assessments of an organization private (AICPA Roadmap 5).

Environmental, Social and Governance (ESG) disclosure is a developing area of financial and nonfinancial reporting. Section I of this chapter will discuss the recent history of ESG disclosures, including examining the reasons for the global increase in ESG disclosures, the public sector and investor demand for ESG disclosures, and the development of guidance and requirements for ESG disclosures from professional organizations. Section II will discuss the relationship between ESG disclosures, the Enterprise Risk Management (ERM) functions within an organization, and the risk appetite of an organization. Section III will identify some specific risks that are currently the focus of ESG disclosures. Section IV will conclude with some thoughts on the future of ESG disclosures.

10.2 What is ESG? What drives ESG objectives and disclosure?

Environmental, Social and Governance objectives take many forms within an organization. ESG disclosures have become material from a reporting perspective because ESG goals are tied to corporate strategy and risk management. In May 2022 comments, SEC Chair Gary Gensler noted the new SEC objectives for requiring ESG disclosures on climate issues as a part of the annual SEC reporting and the disclosure of risk management:

> The first is bringing consistency and comparability to how a management team discloses a company's strategy, governance, and risk management with respect to climate-related risks, building upon the TCFD [Taskforce of Climate-related Financial Disclosures] framework.
>
> The second is disclosure for companies that set targets or use internally developed target plans, transition plans, scenario analyses, or carbon pricing as part of their risk management process.
>
> If you, the reporting company, have a target, under the proposal you would need to disclose your plans to get to that target. If you have a transition plan, you will need to provide disclosure about that plan. If you employ scenario analysis or use internal carbon pricing as part of your risk management, then you would disclose those too. It's up to a company to determine whether to have a target, transition plan, scenario analysis, or carbon pricing. If a company chose not to make those statements or use those tools, no disclosure would be required. The decision on whether to make these statements or use these tools, though, remains entirely up to you as the company.
>
> To the extent that the proposed disclosures would include some forward-looking statements, such as projections of future risks or plans related to targets or transitions, the forward-looking statement safe harbors pursuant to the Private Securities Litigation Reform Act would apply, assuming certain conditions were met. (Gensler 2022)

These comments illustrate the challenges in using current ESG information to evaluate corporate performance, the issues of often incomplete and inconsistent disclosure.

10.2.1 Defining the structure and content of ESG objectives and disclosures

Unlike United States Generally Accepted Accounting Principles (GAAP) based standards created for the format of traditional financial statements (Balance Sheet, Income Statement, etc.), ESG disclosures have differing formats and are not regulated by a central accounting authority. ESG information is usually more similar to management accounting information in that the information is tied to specific operational aspects and strategic goals of an organization. The differences in format are also based on the fact that the information is objective based, and the sustainability objectives are determined by the individual organization, rather than a regulatory authority.

> Sustainability performance (or related nonfinancial data) has unique characteristics. It is less tangible and more qualitative than financial performance data – although sustainability data is often quantifiable, as reported by companies in sustainability and corporate social responsibility (CSR) reports. It is also more forward-looking, covering multiple time periods, and often more manually sourced. To improve confidence in sustainability performance data, a different "lens" on assurance and materiality may need to be taken relative to financial data, with professional judgment at the forefront (Herz, 2017, 7).

This "lens" is sometimes referred to as the sustainability lens because the data used is derived from feedback from operational objectives but focused on nonfinancial sustainability goals.

Concern with using forward-looking ESG information is valid, as forecast models must be built on reasonable assumptions.

> Many organizations and investors already use scenario analysis for anticipating future states for other risks, including climate-related risk assessments as part of their risk management and strategic planning processes. [There are] references to entity examples and climate-related scenario analyses from the Intergovernmental Panel on Climate Change (IPCC) and International Energy Agency (IEA). These examples and those in the TCFD's [Taskforce of Climate-related Financial Disclosures'] Technical Supplement: The use of scenario analysis in disclosure of climate-related risks and opportunities provide detailed information on applying scenario analysis to climate-related risks. This tool can also be applied to other ESG-related risks (e.g., regional water availability, outsourcing labor cost models), which could emerge in distinct ways over time. (COSO Compliance Risk Management 2020)

Some professional organizations have provided guidance on best practices for the scope and format of ESG Disclosures. One major accounting authority providing guidance in the ESG disclosure space is the *Committee of Sponsoring Organizations of the Treadway Commission* (COSO). COSO is a professional organization comprised of 5 major accounting reporting standard setting bodies, the *American Accounting Association* (AAA), the *American Institute of Certified Public Accountants* (AICPA), the *Institute of Management Accountants* (IMA), the *Institute of Internal Auditors* (IIA) and the *Financial Executives Institute* (FEI). COSO has been instrumental with post-Sarbanes-Oxley (SOX) guidance on risk assessment and has taken an active role in the developing the current ESG framework. After the passage of SOX in 2002, COSO produced a series of white papers by authors who were active in the profession on the implementation of Enterprise Risk Management (ERM) strategies. ERM contemplates an organization-wide approach to risk, a proactive and continuous attention to evaluation potential risk. COSO continued this mission of providing guidance by producing papers concerning risk and cybersecurity and other emerging issues. As the demand for ESG disclosures has grown, COSO has developed practical implementation guidance and an analysis of the risk attached to ESG disclosures, using the ERM comprehensive framework. Viewing ESG disclosures as a part of the entire organizational risk structure helps to define the underlying objectives for sustainability disclosures and the scope and format of the information necessary to provide meaningful disclosures.

In a 2018 publication, *Applying enterprise risk management to environmental, social, and governance-related risks*, COSO examines and attempts to define ESG-related risk and related disclosures, noting the vast differences in scope of ESG disclosures in different organizations:

> ESG-related risks are the environmental, social, and governance-related risks and/or opportunities that may impact an entity. There is no universal or agreed-upon definition of ESG related risks, which may also be referred to as sustainability, non-financial or extra-financial risks. Each entity will have its own definition based on its unique business model; internal and external environment; product or services mix; mission, vision, and core values and more. The resulting definition may be broad (for example, may include all aspects of the International Integration Reporting Council's (IIRC) six capitals, []) or narrow (for example, may include only a selection of priority environmental and social issues) and may evolve over time. (COSO and WBCSD 2018)

Since ESG disclosures are so closely tied to the strategic plan of an organization, some organizations may choose not to provide all ESG risk related information to the public. One challenge on ESG reporting is that if the ESG reporting is not compelled for compliance reasons, there is no set format for consistent review of progress on social goals in comparison with other organizations. Indeed, even within the same organization there is no requirement that the disclosures remain in the same format, with the same scope each year. There is no requirement that organizations provide ESG reporting at all. So, organizations may choose a very selective approach on the ESG items that they choose to report on in any given year.

10.2.2 Global ESG disclosure guidance

There is no one consistent authority for ESG reporting, and this has opened up a wide variety of best practices consulting. Some existing guidance from global accounting organizations to support external ESG-related risk disclosures include the Sustainability Accounting Standards Board, the United Nations Sustainable Development Goals. There are also Climate Change advocates, the Climate Disclosure Standards Board (CDSB) and the Taskforce of Climate-related Financial Disclosures (TCFD). Finally, the Global Reporting Initiative (GRI) and The International Integrated Reporting Council (IIRC) encourage a comprehensive reporting model that puts ESG information within the larger context of financial reporting.

The Sustainability Accounting Standards board (SASB) provides an Implementation Guide and Reporting Guidelines Financial filings, the most widely used framework. The SASB provides a framework for management to assess financial materiality of sustainability issues, considering risk, for inclusion in financial reports and recommends minimum disclosure requirements by sustainability issue, covering many industries.(SASB.org)

As we face global problems and critical issues with politics, criminal justice issues and climate change, governments, and groups of interested individuals have put pressure on organizations to provide transparency for their operations. One example is the United Nations Sustainable Development Goals that offers 17 ESG-specific reports encouraging objective setting through these specific goals. (UN SDG)

An example of a specific sustainability issue motivating disclosure is climate change, where interested groups have sought accountability for repair of past harm done by organizations and some outside groups have pushed organizations to set higher social goals in the context of their strategic planning. In a profound way, global demand for ESG disclosures has centered around the interrelated nature of risk and ESG goals as assessed by a broad societal view. There are many groups that assess the global impact of the actions of organizations and attempt to create a priority of action on some social goals. The Climate Disclosure Standards Board (CDSB) provides a Framework Financial filings and annual reports. In CDSB guidance recommends reporting requirements for disclosing environmental information in mainstream reports where that information is material to an understanding of companies' financial risks and opportunities, as well as the resilience of their business models. The Taskforce of Climate-related Financial Disclosures (TCFD) recommends voluntary disclosures for companies to report on governance, risk management and impacts of climate change on the organization and provides industry-specific guidance.

Some organizations embrace a more comprehensive reporting model. Global Reporting Initiative (GRI) ESG-specific reports provide a widely adopted framework for reporting material economic, environmental, social and governance issues and advises reporting on topics that present risks to a company's business model or reputation. The International Integrated Reporting Council IIRC advocates <IR> Framework Annual reports that provide a framework for integrated reporting on all six capitals (i.e., financial, manufactured, intellectual, human, social and relationship, and natural). With regard to ESG and Risk, the IIRC advises entities to disclose the specific risks that affect the ability to create value over the short, medium, and long term and how the organization manages them.

One example of this effort to create social goals and prioritize efforts of organizations to add strategic responses to their business plans is the World Economic Forum:

> Each year, the World Economic Forum's Global Risks Report surveys business, government, civil society and thought leaders to understand the highest rated risks in terms of impact and likelihood. Over the last decade, these risks have shifted significantly. In 2008, only one societal risk, pandemics, was reported in the top five risks in terms of impact. In 2018, four of the top five risks were environmental or societal, including extreme weather events, water crises, natural disasters, and failure of climate change mitigation and adaptation. The World Economic Forum also highlights the increasing interconnectedness among ESG risks themselves, as well as with risks in other categories – particularly the complex relationship between environmental risks or water crises and social issues such as involuntary migration. (COSO and WCBSD 2018, 2)

10.2.3 The investor demand for ESG objectives and disclosure

Investor interest in ESG issues has also motivated most companies to respond with more comprehensive disclosures in a serious way.

> There is also growing interest from investors seeking to understand how organizations are identifying and responding to ESG-related risks. In recent years, environmental and social proposals in the US have accounted for around half of all shareholder proposals submitted – representing the largest category of proposals (the other categories include board, anti-takeover/strategic, compensation or routine/other). (COSO and WBCSD 2018, 4)

Recognizing the increased demand for ESG reporting, in 2016 the Securities and Exchange Commission (SEC) polled investors and issuers to determine stakeholder feelings about whether the SEC should mandate ESG disclosures.(Ho 115) The SEC has not yet revised regulations to increase ESG reporting requirements:

> One reason may be the sharp divergence between investors and issuers on whether the problem ESG reform must solve is a question of underreporting or disclosure overload. Eighty-three percent of all respondents in this study support expanding ESG disclosure in some form, with 13% opposed. As Figure 2 shows, 96% of investor comments and 78% of "other" respondents on this issue supported expanded ESG disclosure, compared with only 15% of issuers. Surveys of institutional investors and corporate boards since 2016 indicate that recognition of ESG materiality has grown stronger among both groups since then, suggesting that support for ESG disclosure would be stronger if the SEC were to pose the same questions today. Interestingly, of the 17 law firm comments included in this study, only 7 (41%) supported ESG disclosure reform. (Ho 115)

Fulfilling the expectations of investors can be challenging to an organizations. Unlike the established framework for reporting financial statement information under US GAAP, there was traditionally little guidance on the content of these ESG disclosures which are supplemental information to the financial statements and include financial and nonfinancial information. As a result of this lack of standard format for ESG disclosures, there is a challenge of creating a consistent method of providing assurance and auditing of the ESG disclosures.

Auditors want to have verifiable information in ESG disclosures that are meant to show organizational progress on social goals and objectives. This is why certain parts of the financial reporting are not reviewed by auditors, such as forecasts and soft information. Because ESG disclosures have this type of soft information and forecasting it provides a challenge to assurance. (AICPA Roadmap 2021, 15)

Reporting on social goals follows less of a US GAAP based format but is more similar to managerial accounting disclosures. Because of this the scope and nature of disclosures are not mandated. Existing risk must be evaluated as a part of the analysis of the current situation. Also, the evaluation of potential risk involves an element of forecasting. Forward-looking information must be based on reasonable assumptions to be effective.

10.2.4 ESG disclosure trends

Either on a voluntary basis or compelled by regulation or investor groups, most large organizations have responded to the trend to providing ESG disclosures. It was noted by COSO that over 85% of fortune 500 companies provided some type of ESG disclosure in 2017. (COSO and WBCSD 2018, 91)

COSO noted the increase of mandatory ESG disclosures across the globe: "There has also been growth in ESG-related regulation and disclosure requirements – totaling 1,052 requirements (80% of which are mandatory) in 63 countries." (COSO and WBCSD 2018, 91)

The European Union and Singapore have instituted mandatory ESG Disclosures:

> From 2017, the European Union Directive on Non-Financial Reporting requires that companies that operate in EU member states and meet certain criteria prepare a statement containing information relating to environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, and diversity on boards. Regulatory bodies and stock exchanges are also responding to growing investor demands for uniform ESG information linked to financial performance.
>
> In 2017, Singapore introduced a listing rule for listed issuers to prepare an annual sustainability report, identifying material ESG factors, policies, practices, performance, targets, and a board statement. (COSO and WBCSD 2018, 91)

10.3 COSO view: ESG objectives and disclosures and enterprise risk management

Organizations with solid internal control procedures gather a lot of information on current and emerging risks. The risks of any strategy including ESG strategies are evaluated in the context of Enterprise Risk Management (ERM). Organizations develop risk tolerances as a part of the ERM process and continuing and emerging risks are evaluated using the 5-part ERM analysis. Once ESG related strategies are in place, an organization considers the content of ESG disclosures, potential opportunities, and disadvantages, along with challenges to auditing risk related information. Finally, we will discuss trends in future disclosure and potential impact.

10.3.1 Internal controls: Enterprise risk management and risk assessment

Risk Management is a process used by for profit and nonprofit organizations in their strategic planning, internal control, and assessment, and it an exercise of professional judgment for the board of an organization. (Glover 3) Professional judgments are best made through a consistent process, for example the KPMG Professional Judgment Framework takes a 5-step approach. The five steps in this Professional Judgment process are 1) defining the problem, 2) considering alternatives, 3) gathering information, 4) reaching a conclusion and 5) communicating the conclusion to all levels of the organization. (Glover 3)

After the Sarbanes-Oxley Act (SOX) of 2002 was passed in response to the accounting scandals of the 1990s, the *Committee of Sponsoring Organizations of the Treadway Commission* (COSO) developed guidance on *Enterprise Risk Management* (ERM) as a part of the commitment to internal control. ERM is a comprehensive process where the leadership of organizations (the Board of directors) determine risk appetites and assess Key Risk Indicators (KRI) including social and political risk factors as a part of an overall ongoing evaluation of performance and strategic decision-making. (Anderson 2020)

In the post SOX years, the added commitment that organizations made to accountability through strong internal control, corporations also sought to demonstrate to investors their action towards implementing policies concerning sustainability and social goals. In addition to the demand for stronger internal controls, investors have demanded accountability from organizational leadership as to sustainability and social goals. Recently Environmental Social and Governance-related Risks (ESG) reporting has met the demand for additional required disclosures of ESG impact in addition to other financial disclosures (COSO and WBCSD 2018).

ESG disclosures are investor-facing presentations of financial and nonfinancial information, measure and present Criminal Justice, Social and Political risks. It is interesting to note how the structure of ESG disclosures are shaped by the work that COSO has done on ERM, which is usually done for use solely within the organization, and how a study of interaction between organizational risk appetites and KRI identification will shape the external reporting of social and political risk in the context of organizational strategic goals.

The ERM process: The ERM process as created by COSO contemplates applying strategy challenges to the complexity of structure in an organization. (Anderson 2020) The COSO cube illustrates the interactivity of the internal control function within an organization.

The starting point of internal control is that the board of directors should establish risk tolerances and communicate these risk tolerances to the management levels of the organization. Internal auditors then evaluate the actual performance of the organization against these risk tolerances (Patchin 2012)

Key Risk indicators: In addition, the internal control function within a company must identify KRI Key risk indicators that will identify where potential future risk lies for the organization KRIs. (Beasley 2010) These KRIs are separate from Key Performance Indicators (KPIs), which measure whether actual real-time performance of an organization meets expectations. KRIs are rather an examination of trigger events that might cause significant change due to risk in the organization. (Patchin 2012)

10.3.2 Before ESG objectives and related disclosures: Risk appetite should be well communicated and understood within the organization and incorporated into strategy

Simply put, an organization needs to have a well-developed and clearly communicated set of risk appetites, and to apply these to strategic decision-making on a consistent basis. While this is a process that requires systematic periodic evaluation, it is also important to note that some organizations have a professional culture that embraces this process and for others the internal processes of communication are not as well developed (Patchin 2012)

Transparency of risk appetites within an organization must begin with the top management communication of risk appetites to everyone in the organization that is working to achieve strategic goals of the organization. In the COSO White Paper "*Risk Appetite-Critical to Success Using Risk Appetite to Thrive in a Changing World*," COSO defines risk appetite as "The types and amount of risk, on a broad level, an organization is willing to accept in pursuit of value"(Rittenberg 2012) In order to be an effective tool for an organization, risk appetites must be tied to the strategy of the organization, but the authors of the white paper urge companies to go beyond just measuring actual risk as a metric, and work towards having the workers at every level of an organization understand the philosophy of the risk appetite as set by the top management of the corporation, in order to come up with strategic innovations at all levels of the organization.

> ***Risk appetite is much more than a metric***. Often, it is treated as part of an approach where each metric is assigned a target appetite. Although such an approach is important, a better application of risk appetite can lead an organization to proactive, forward-looking opportunities that tie appetite and strategy together for future action. (Rittenberg 2012)

Discussions on risk appetites established by the board and top management are an important part of communicating organizational strategy throughout an organization. These discussions can include ESG issues such as climate related objectives.

> ***Risk Appetite helps increase transparency***. A well-formed and communicated risk appetite provides awareness of the risks the organization wishes to assume as well as those it wishes to limit. (Rittenberg 2012)

It is a challenge for management to apply the abstract concept of risk appetites and risk management to decision-making and implementation of strategy unless there is clarity and guidance from the board. Institutional policies can also be created to reflect the risk appetites. (Rittenberg 2012).

To be effective, appetite must be:

- Operationalized through appropriate tolerances, and where necessary, codified through policy
- Stated in a way that assists management in decision-making
- Precise enough to be useful in making decisions and in monitoring by management and others responsible for managing risk
- Applied by those with decision-making authority from the board through senior and middle management on down into the entity (Rittenberg 2012)

10.3.3 Implementing risk appetites in organizational operation through the 5-part COSO ERM framework

Once a risk appetite is established by the board, in order to be effective, the risk appetite must become a living part of the day-to-day strategic operation of the organization.(Galligan 2015) The goal of integrating the risk appetites within the organization is accomplished through the final step in the five-part COSO ERM framework, a continuous review of risks in the organization. The five principles associated with the management of compliance risks within organizational operation are 1) to identify risk 2) to assess severity of risk 3) to prioritize risk 4) to implement risk responses 5) to develop a portfolio view. (DeLoach 2014)

Step 1 is risk identification. In order to convey a clear understanding of risk tolerances the board must describe the compliance risk identification and assessment process in documented policies and procedures. In addition, documentation within the organization must identify compliance risks associated with planned strategy and business objectives . This assessment of strategy includes scanning internal and external environments to identify risks and creating a process for identifying new and emerging risks. (DeLoach 2014)

Step 2 is assessment of risk severity, again the process should be systematic:

- Adopt a uniform scale/scoring system for measuring severity of compliance risks
- Consider qualitative and quantitative measures
- Establish criteria to assess impact and likelihood of compliance risk event occurrence
- Assess severity of risk at different levels (organizational, regional, affiliate, etc.)
- Consider design and operation of internal controls intended to prevent or detect compliance risk events
- Minimize bias and inadequate knowledge in assessing severity (e.g., minimize self-assessments, use multidisciplinary teams) (DeLoach 2014)

Step 3 is prioritizing risk responses:

- Prioritize compliance risks based on assessed level of risk relative to meeting of business objectives

- Use objective scoring based on assessment
- Consider use of other assessment criteria (trend, velocity, etc.) in prioritizing compliance risks
- Consider possible effects of planned changes in strategy and operations
- Develop risk-based action plans for mitigation (risk responses, implemented in next step)(DeLoach 2014)

Step 4 is implementing risk responses:
- Design compliance risk responses that consider the impact on other (non-compliance) risks and risk responses
- Assign accountability for each compliance risk response (including timeline, etc.)
- Follow up to determine whether compliance risk responses have been properly implemented as designed
- Consider compliance risk responses when developing monitoring and auditing plans (DeLoach 2014)

Step 5 is developing a portfolio view or an overall organizational view of risk. At the broader level, the board considers risk interactions (i.e., how mitigating a compliance risk can affect other risks). Having regular meetings/communications between compliance and business units assists this process. (DeLoach 2014)

10.4 ESG risk: Objectives risk and disclosure risk

10.4.1 ESG objectives risk: Integrating ESG and sustainability into strategy

The history of ESG stems from a movement for greater sustainability disclosures. The triple bottom line philosophy encouraged organizations to engage in a separate process of sustainable disclosures. The COSO white paper released in 2013 closes with a reiteration of the practical benefits of using the triple bottom line and social auditing practices as a part of corporate strategy. “Organizations that choose to embed sustainability into a COSO-based risk management program can achieve the following competitive advantages:”(Faris, et al. 2013, 11)

First, the white paper shows a holistic view of the corporation reveals a strong connection between sustainability and strategy.

> **Alignment of sustainability risk appetite to the organization’s corporate strategy and the new world view of company value.** Having a holistic view of sustainability risk that looks across the entire enterprise enables organizations to do a better job of anticipating and responding to issues as they arise. (Faris, et al. 2013, 11)

Sustainability Objectives and related ESG disclosures should be prepared in a way that allow corporations a better understanding of the global environment in which they operate. This added level of review that an ESG objective provides improves operational performance because it allows familiar issues to be viewed in a new way.

> **Expanded visibility and insights relative to the complexity of today's business environment.** Embedding sustainability into an organization's ERM framework enables the sustainability function to gain valuable insights regarding the sustainability risks the organization faces and the materiality of those risks. These are insights the sustainability function can then share with management and the board so that they have a clear understanding of the sustainability risks relative to the complexity of the business environment. (Faris, et al. 2013, 11)

When corporations embrace sustainability, the corporation demonstrates that they find value in intangible and nonfinancial goals; and that the decision makers within the corporation understand the connection between sustainability goals and strategic success.

> Stronger linkage of company values and non-financial impacts to the organization's risk management program. Identifying sustainability risks and opportunities can be challenging. However, organizations that understand how to link them to their value drivers are better able to understand the impacts on the business in non-financial ways. (Faris, et al. 2013, 11)

Using a "*sustainability lens,*" considering sustainable goals as a part of overall operational strategy, is an additional level of review, and this additional level of review can provide definite benefits. The additional level of review that a sustainability lens provides helps make strategy and operations more effective, comprehensive, and innovative. Management must also incorporate a long-term approach for sustainability goals, and this long-term consideration can benefit other comprehensive program goals. (Faris, et al. 2013, 11)

The implementation of this *"sustainability lens"* can also be a benefit as an aspect of reputation management, as stakeholders perceive a more aware and effective management team, a management that is in tune with social and sustainability needs. (Faris, et al. 2013, 11)

> **Better ability to manage strategic and operational performance.** Organizations can create competitive advantage by managing sustainability risk to improve business performance, spur innovation and boost bottom- line results. Companies that conceive their products or services through a sustainability lens will attract funding from external investors and boost stakeholder confidence. Sustainability as part of the value proposition is also becoming as relevant to market capitalization as innovation or R&D. (Faris, et al. 2013, 11)

Finally, the Social Audit practices connected with sustainability help corporations to deploy capital in the most efficient way to achieve sustainability and systematic goals. The corporation can examine the benefits and multiple efficiencies achieved with effective capital deployment.

> **Improved deployment of capital.** Organizations that have used the COSO ERM Framework to embed sustainability risk management practices have better opportunities to allocate capital more effectively – in ways that maximize capital efficiency or that send the right messages to stakeholders based on the organization's corporate values and strategy, but in all ways enable the organization to reach its sustainability and, more importantly, its corporate objectives. (Faris, et al. 2013, 11)

10.4.2 ESG disclosure risk: Would mandatory SEC reporting on ESG cause disclosure overload?

On May 25, 2022, the Securities and Exchange Commission (SEC) proposed amendments to rules and reporting forms to promote consistent, comparable, and reliable information for investors concerning funds and advisers' incorporation of environmental, social, and governance (ESG) factors. The process of incorporating ESG disclosures into annual SEC reporting indicates a shift in the attitudes of the SEC towards ESG and its materiality to the comprehensive view of the corporate management strategy. (SEC Press Release 2022) In March 2021, the SEC created a Task Force on ESG reporting. (SEC Press Release 2021) (Posner 2022), and the result of the work of this group is a series of proposed amendments. SEC Chair Gary Gensler noted. "ESG encompasses a wide variety of investments and strategies. I think investors should be able to drill down to see what's under the hood of these strategies. This gets to the heart of the SEC's mission to protect investors, allowing them to allocate their capital efficiently and meet their needs."(Katz 2021) Industry professionals called the announcement of the proposed amendments regarding ESG disclosures a "watershed " moment in the development of ESG disclosure requirements(McKee, et al. 2022).

The Proposed amendments refer to investment funds with an ESG focus, with a goal of preventing false or misleading disclosures:

> While the Commission has not generally prescribed specific disclosures for particular investment strategies, ESG strategies differ in certain respects that we believe necessitate specific requirements and mandatory content to assist investors in understanding the fundamental characteristics of an ESG fund or an adviser's ESG strategy in order to make a more informed investment decision. First, the variation discussed above concerning ESG investing, combined with the lack of a more specific disclosure framework, increases the risk of funds and advisers marketing or labelling themselves as "ESG," "green," or "sustainable" in an effort to attract investors or clients, when the ESG-related features of their investment strategies may be limited. (SEC Proposed Amendment 2022)

The Securities and Exchange Commission (SEC) first considered expansion of required ESG disclosures within the S-K regulations, in 2016 questions to stakeholders. (Ho 115) How do we determine the proper scope of SEC required disclosures? Are existing voluntary ESG disclosures enough in the minds of investors? The polled investors did not feel that voluntary ESG disclosures provided adequate information:

> Although 46% of all comments by companies and business organizations argued that voluntary sustainability reporting outside the federal disclosure regime adequately meets investor needs, less than 1% of investors thought so. In fact, 96% of investors asserted, often strongly, that ESG information contained in these reports is inadequate for investment purposes and costly to analyze. They stress that in the absence of a standardized ESG reporting framework, investors must glean material in-formation from among immaterial information in voluntary sustainability reports that is directed at other stakeholders and often available only from individual company websites that investors must scour at their own cost. (Ho 120)

> The SEC considered this feedback:
> For these reasons, the SEC's own Investor Advisory Commission was among those urging the SEC to consider the need to develop a framework for ESG risk disclosure. The majority of investors cited two primary reasons why voluntary sustainability reporting is inadequate. The first is that the broader stake- holder-orientation of most voluntary reports means they are not subject to the same investor-oriented materiality standards that apply to public filings. The second is that the plethora of reporting frameworks and standards reduce the comparability of any resulting data. Comments from the American Institute of Certified Public Accountants also noted that the majority of public companies do not connect the personnel and processes associated with sustainability reporting to those responsible for financial reporting. (Ho 121)

On the issue of whether disclosure overload would overwhelm investors, the SEC 2016 inquiry found the following:

> In short, companies and business groups were more likely to express concerns about investors' information overload than investors themselves. Many investors noted that advances in technology permitting machine reading and automated analytics enable efficient analysis of more extensive disclosures, provided that the information is presented in a comparable format, and that over disclosure concerns are therefore outdated. These comments emphasize the importance of consistency and comparability, which is difficult to achieve solely through principles-based disclosure. (Ho 121)

One important concept is whether disclosure is material for investor understanding of potential investment. In 2016, the SEC noted that it had changed its position on the materiality of ESG information from its stated viewpoint in 1975:

> noted in the Concept Release, the SEC determined in 1975 that "disclosure relating to environmental and other matters of social concern should not be required of all registrants unless appropriate to further a specific congressional mandate or unless, under the particular facts and circumstances, such matters are material." In the Concept Release[2016], the SEC for the first-time sought comment on precisely this issue – the extent to which "public policy and sustainability matters" are now considered to be material in terms of their "importance . . . to informed investment and voting decisions, "and to identify such issues specifically. (Ho 116)

The comments obtained by the SEC in 2016 indicated that investors felt that materiality of ESG disclosures should be industry driven, and reflective of market risk issues.

> Thirty-three percent of all comments on section IV.F agreed that ESG materiality is sector specific. In addition, nearly 20% of the 219 investors who responded to questions in this part of the Concept Release identified ESG factors as material to systemic, market, or portfolio-wide risk, while no issuer responses did so. Comments identified a wide range of material ESG issues; those raised most frequently included climate risk and environmental matters, political contributions, human rights, and international tax strategies. The potentially broad scope of circumstances that may render specific ESG information material is a concern of some companies and counsel with respect to potential ESG disclosure. Several investors, however, emphasized that under the SEC's materiality standard, information is material based on its importance to the "total mix" of information rather than because of its significance in isolation. (Ho 116)

10.5 Conclusions: The future of ESG objectives and disclosures

Discussing organizational assessment of social and political risks is at the heart of ESG disclosures. Making progress towards ESG goals is only possible if the related risks are accurately assessed and these risk assessments are appropriately applied in the creation of strategic plans and operation, as well as in the disclosure process. ESG programs are best served when there is a continuous ERM process of assessment of risk, implementation of these risk assessments into ESG programs, and measurement of progress toward social goals. ESG disclosures provide transparency in the measurement of these social goals to the public stakeholders.

Thinking about the future of ESG here are some essential factors:

- ESG disclosures have already become an essential part of external reporting, through transparency of financial and nonfinancial information to stakeholders such as investors and global regulators.
- ESG disclosures express the approach the organization has to meeting social goals and provide an opportunity to discuss the timeline and success or failure of social goals. Because ESG disclosures are issue specific reporting can be tailored to cover ongoing progress to a goal, not just focused to a specific year.
- ESG disclosures should express the risk appetites that are developed through ERM and applied internally in an organization. The internal attitudes and assessment of risk within an organization are fundamental to creating successful programs to meet social goals.
- The scope and accuracy of ESG disclosures also depends on an understanding of the needs of investors. The investors have started a push for standardization through required disclosure. In contrast to reporting organizations, concerns about disclosure overload are dismissed by investors. Because investors desire a standardized format to analyze ESG performance, SEC mandated ESG disclosures will be a future step in ESG regulatory compliance.

The process of ESG disclosures is drawn from the internal control processes of an organization. Understanding ERM policy of a company and its risk appetites helps to see how the organization develops strategies to meet social goals.

As more transparency is demanded there will be development of more consistent forms of ESG disclosures that are verifiable through audit and assurance standard procedures.

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