TONE at the TOP®

Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

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COVID-19: Enhancing the Value of Governance

During chaotic times, how do boards best fulfill their critical oversight role? That's a compelling question for many directors right now, given the multitude of disruptions that organizations are facing. The consequences of the lingering COVID-19 pandemic seem to multiply daily, with organizations encountering new levels of complexity and risk. And there is a growing list of uncertainties emerging in other areas, including new technologies that change traditional ways of doing business, and new demands from shareholders on a number of fronts.

ESG Concerns at the Forefront

In particular, the last couple of years have highlighted the need for boards to focus on issues that fall under the ESG category — environmental, social, and governance. ESG addresses how organizations impact the world around them, which presents a different set of considerations than traditional financial challenges. "This broad risk category includes areas that are dynamic and often driven by factors that can be difficult to measure objectively, such as inclusion, ethical behavior, corporate culture, and embracing sustainability across the organization," according to Internal Audit's Role in ESG Reporting, a white paper from The Institute of Internal Auditors.

Stakeholders and regulators of all stripes are taking ESG issues into consideration. The U.S. Securities and Exchange Commission sought public comment on climate change disclosures and is developing a climate risk disclosure rule proposal.[1] A report by the National Association of Corporate Directors found that almost 80% of public-company boards engage with ESG issues in some way, mainly to ensure links to strategy and risk.[2] Earlier this year, a KPMG poll revealed "a marked increase in CEOs taking active positions on long-standing social issues, which came into sharp relief during pandemic tensions." The data suggest this emphasis will continue.[3] Investors also are shifting their focus. A JPMorgan Chase & Co. report asserts that the pandemic could prove to be a major turning point for ESG investing long-term. It noted that 71% of investors thought it was likely, rather likely, or very likely that "a low probability/high impact risk, such as COVID-19, would increase awareness and actions globally" of the need to address risks such as those associated with climate change and biodiversity losses.[4]

Internal Audit and ESG

As board members are deluged with more and more ESG data to use in their governance role, they can turn to internal audit for beneficial assurance, advice, and input. Internal audit is already poised to take on this responsibility. "Although an independent audit of ESG reporting is not currently required, internal audit functions are increasingly involved, performing assessments of the underlying internal control framework, supporting publicly available information, and validating the completeness

About The IIA

The Institute of Internal Auditors, Inc. is a global professional association with more than 210,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

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and accuracy of the data used in reporting," according to a Deloitte article.[5] The Center for Audit Quality found that 95% of S&P 500 companies made detailed ESG information available.[6]

No matter what level of ESG reporting an organization is performing or what type of detail a board may need, a comprehensive, objective, and independent review by internal audit can add value. Beyond sustainability reporting, internal audit can offer assurance on all aspects of ESG risk management. This is particularly valuable for board members who lack experience with ESG issues. Indeed, directors (75%) don't believe their boards have a strong understanding of ESG risks, according to data from PwC's 2021 Annual Corporate Directors Survey (see Figure 1).

A holistic approach that embraces not only financial strategies and metrics but also those related to ESG factors is considered indispensable to long-term value creation, according to the IIA white paper. Because of its knowledge of the entire organization, internal audit can identify policies, controls, and responsibilities and use an integrated approach that takes risk strategy and appetite into account. Organizations can call on internal audit to:

- Provide an independent and objective review of the effectiveness of ESG risk assessments, responses, and controls that the board can use in decision making.
- Monitor regulatory requirements in specific states or foreign jurisdictions and provide updates on the organization's compliance status.
- Help organizations meet a variety of information requests from various stakeholders, such as investors, banks, customers, and business partners.[7]

A Focus on Governance

For directors worried about the many obstacles facing their organizations, the positive news is that good governance is the solid foundation that boards and organizations can rely on to weather such challenges, including ESG issues. Governance typically refers to how an organization is directed and managed, how its rules, practices, processes, and controls support and achieve its objectives. It is encouraging that governance remains top of mind for board members and key executives. According to The IIA's *OnRisk 2022: A Guide to Understanding, Aligning, and Optimizing Risk*, 78% of board members, C-suite executives, and CAEs identified organizational governance as having a high risk relevance.[8]

As part of their good governance arsenal, organizations can turn to The IIA's Three Lines Model for help in identifying structures, designing processes, and assigning responsibilities to enable them to achieve their goals and support strong governance and risk management.[9] Grounded on six key principles, the

QUESTIONS FOR BOARD MEMBERS

» Are current company strategies and goals still appropriate after the disruptions of the past year?

» Has the board reevaluated mission-critical risks in light of the pandemic?

» Does the board have the information or expertise it needs to assess ESG risks?

» What good governance approaches have been most effective during the last two years?

model encourages organizations to consider the roles needed for effective governance to help foster success. It sets forth the relationships between the governing body and management, between management and internal audit, and between internal audit and the governing body. It establishes that internal audit is “independent from the responsibilities and decisions and interference of management and is accountable directly to the governing body.” It points out that governance requires appropriate structures and processes that allow for:

- Accountability by a governing body to stakeholders for organizational oversight through integrity, leadership, and transparency.
- Actions (including managing risk) by management to achieve the objectives of the organization through risk-based decision making and application of resources.
- Assurance and advice by an independent internal audit function to provide clarity and confidence and to promote and facilitate continuous improvement through rigorous inquiry and insightful communication.[10]

Objective Assurance, Insights, and Advice

Boards and their organizations definitely have their work laid out for them. Unfortunately, when it comes to improving governance, there are indications that a certain amount of fatigue has set in, according to an early look at The IIA’s *2021 American Corporate Governance Index*. The upcoming report, which is set to publish in January 2022, shows that the pace of some governance improvements made last year slowed or that governance quality even receded this year. The annual report on the health of governance among publicly traded companies is produced by The IIA and the University of Tennessee’s Neel Corporate Governance Center.

However, when boards do maintain a strong focus on governance concerns, they will be better prepared for whatever challenges arise. What is clear is that strong governance over ESG — and effective governance overall — requires alignment among the principal players. As is the case with any risk area, internal audit is well-suited to support the governing body and management with objective assurance, insights, and advice on ESG matters.

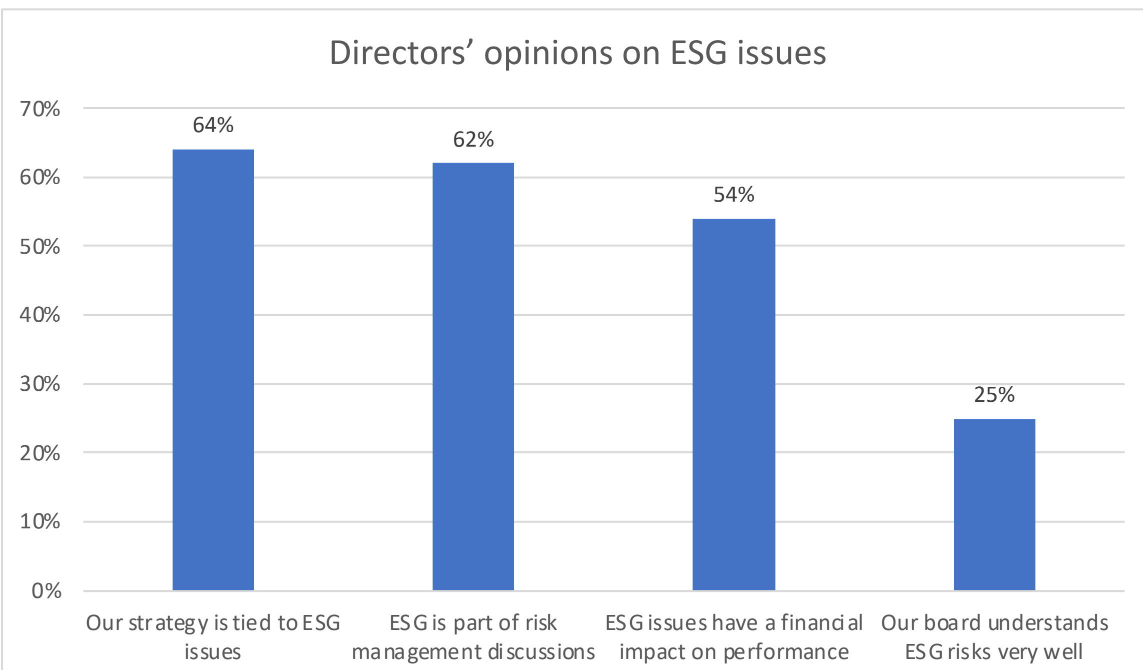

Figure 1 - Source: PwC’s 2021 Annual Corporate Directors Survey

[1] "SEC Response to Climate and ESG Risks and Opportunities," Securities and Exchange Commission, March 2021.
[2] *2019-2020 NACD Public Company Governance Survey*, NACD, 2019.
[3] "Sustaining ESG momentum in post-pandemic world," KPMG, March 20, 2021.
[4] "Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing," JPMorgan Chase & Co., July 1, 2020.
[5] "ESG and the Role of Internal Audit," *Wall Street Journal CFO Journal*, September 29, 2021.
[6] *S&P 500 and ESG Reporting*, Center for Audit Quality, August 9, 2021.
[7] "Internal audit has pivotal role in ESG reporting," Ken Tysiak, *Journal of Accountancy*, July 7, 2021.
[8] *OnRisk 2022: A Guide to Understanding, Aligning, and Optimizing Risk*, The Institute of Internal Auditors, 2021.
[9] *The IIA's Three Lines Model*, The Institute of Internal Auditors, 2020.
[10] *The IIA's Three Lines Model*, The Institute of Internal Auditors, 2020.

Quick Poll Question

Is corporate governance in your organization healthy enough to manage new risk challenges, such as ESG?

- ❏ Yes, absolutely.
- ❏ We may struggle a bit, but we manage.
- ❏ We do not manage new risk challenges well.
- ❏ I don't know.

Visit www.theiia.org/Tone to answer the question and learn how others are responding.