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The European Voice of Directors

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ESG embedding: are you ready?

a call for Boards, Risk Managers and Internal Auditors

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I - Context

This paper, prepared by the three respective European organisations, shows why Directors, Risk Managers and Internal Auditors should act now so their companies can fulfil their sustainability responsibilities and expectations.

Embracing the European sustainability challenge will require a comprehensive understanding of the organisation, its strategy, business model and value chain; and the impacts, risks and opportunities that it faces. Cooperation between functions is more important than ever, particularly on ESG as it is a truly transversal topic.

This paper, prepared by ecoDa on behalf of Governing Bodies, FERMA representing European Risk Managers and ECIIA representing Internal Auditors, focuses on good governance. Governance models such as the Three Lines[1] foster cooperation among all functions and operations within a company, so that sustainability can be truly embedded in business operations and strategic sustainability-related objectives can be achieved.

Risk Management (Second Line) and Internal Audit (Third Line) are key forces to support the Board and Senior Management as essential parts of the Three Lines model, and more broadly.

Regulatory Evolution: CSRD, ESRS and new requirements

The European sustainability reporting standards (ESRS) proposed by the sustainability reporting standards advisory body EFRAG will provide the basis for implementation of the mandatory sustainability disclosures required under the Corporate Sustainability Reporting Directive (CSRD).

EFRAG's proposals are based on the principle of double materiality, unlike the framework of the International Sustainability Standards Board (ISSB) that will be directed to climate issues and to investor protection. EFRAG's proposed standards focus on 1) how sustainability matters impact reporting companies and 2) how reporting companies impact the environment and society.

With the exception of ESRS standards, the legislative documents do not directly address the impacts of sustainability requirements on Risk Management and Internal Audit. Nevertheless, both functions will have to support Directors when dealing with the new requirements: value chain impacts, stakeholders' views but also leveraging internal assurance (second and third line) and external assurance by an independent party.

1 - The IIA's Three Lines Model

The EU has also issued a proposal for a Directive on Corporate Sustainability Due Diligence (CSDD), which would, among other duties, require companies to integrate due diligence into policies and decision-making. They would need to identify, prevent or mitigate actual or potential adverse human rights and environmental impacts, to be verified by national competent authorities.

II - How requirements are shifting the focus for the three professions

Expectations for Boards

The public push for corporate sustainability and a corresponding level of transparency has dramatically risen over the past 10 years. License to operate will increasingly depend on whether companies contribute positively to sustainability - or at least mitigate adverse impacts of their activities. Public and private companies in the scope of the CSRD must know whether their production processes, products or services can or do result in damage to the environment or people.

This requires a big change for Boards, regardless of company size, and includes smaller businesses that are part of the value chain of bigger companies that come within the scope of sustainability reporting since those companies must scrutinize and vet ESG disclosures to the same degree as any other statements to investors. They should recognize that ESG-related risks can have a significant economic impact on performance and share price. ESG disclosures, especially in sectors with high environmental or social risks, should disclose risks adequately and communicate truthfully and clearly to investors and in public filings.

As part of this process, companies must also identify stakeholders who are relevant to the company and assess the potential impact of their views on the company's policies and action plans.

Misreporting of ESG is already catching the attention of regulators, as shown by the complaint filed in April 2022 by the SEC against Vale S.A., a Brazilian mining company listed on the New York Stock Exchange. In Europe, activists are filing numerous complaints against companies, which signals an increased risk of enforcement actions targeting misrepresentations and omissions in companies' ESG disclosures.

Sustainability is not just a reporting exercise. It will require an enterprise-wide approach to ESG that incorporates opportunities and risks over the long-term.

Organisations are at different stages of maturity in their sustainability approach and have different ways of identifying, analysing, assessing and dealing with the risks and opportunities. We have developed a maturity-level self-assessment matrix (in appendix) that allows organisations to evaluate where they stand in terms of their approach to sustainability and to trigger a discussion internally on how to move forward/to progress.

Shifting expectations for Risk Management and Internal Audit

Risk Management and Internal Audit must help Management and the Board to understand the proposed legislation, and the overall shift on ESG, so risk assessment, risk appetite, policies and governance fulfil the requirements and expectations. In turn, Senior Management and the Board must give Internal Audit and Risk Management the means to do this.

Without a proper internal review and active participation by Risk Managers and Internal Auditors, companies might well stay blind to their actual ESG impacts, there is a risk of increasing the level of wishful thinking or involuntary greenwashing, which will ultimately create a liability risk for management. Some topics are out of the board members' field of vision ("They don't know that they don't know").

The role of the Risk Management and Internal Audit functions becomes critical to bringing out the off-camera, to ask the right questions, but also to formulate possible answers.

Risk Managers and Internal Auditors will be looked upon for their expertise when it comes to establishing the implications for double materiality. They can also help the Board to create appropriate conditions for a real and meaningful dialogue with relevant stakeholders, at the right level.

Consideration of ESG is not yet routine in corporate thinking, and as part of its work, Internal Audit can help to prevent greenwashing. Internal Auditors should consider whether the company is truly and fully engaged, whether Risk Management processes are geared towards effectively probing strategy, and whether the company has set the right ESG culture. They play various roles from advisory and insight to internal assurance.

To anticipate and to warn are two key pillars to the Risk Managers' role. As such, they should be participating in the due diligence process to be carried out on the business model and value chains, as well as attending the dialogue with relevant stakeholders. Even before a risk appetite statement has been formulated Risk Managers will be key in determining the success of the strategy process by assessing not only risks to the execution of the strategy, but also whether the strategy could cause problems in the future, especially during the transition period.

III - Safeguards for Boards

The safeguards that the Board will have to put in place to ensure it meets its responsibilities:

1. Check that risk assessment starts with the actual ESG impacts of the business model including value chain considerations (e.g. product life cycle starting from design through production, use and end-of-life, production model, land use, supply chain impacts, direct and indirect relationships, etc), prioritizing on the most sensitive topics. Also consider how sustainability strategy is integrated into the business model (eco-design; sourcing of supply, but also production site location vs transportation, packaging);

2. Ensure that the information on the companies' externalities is robustly obtained. It might be mostly in-house findings, or management actively looking for external information regarding actual impact on communities, users and the environment. There should also be a process for maintaining a good level of understanding of these impacts; in particular through engagement with stakeholders, including NGOs and activists, after a systematic and objective analysis;

3. Verify that management is using qualified experts who are able to supplement internal knowledge, and due diligence (would they be considered superficial or best-in-class by an independent, reasonably informed, third party?) – Does it include demographic projections, climate change projections, use of weather and water scarcity models, and their corresponding impacts on biodiversity, infrastructures, etc;

4. Assess the strategy against ESG risks or define a strategy that directly respond to current ESG challenges. Check how strategy (in all its dimensions) is impacted by these findings (level of readiness for expected macro physical changes). What is the approach?;

5. Verify that the sustainability information is appropriately prepared (internal controls, information systems), well structured, consistent in approach (gradual convergence, development of company's views on the reporting model), with a clear reference framework, description of methodologies, major estimates and judgments, assurance obtained on disclosures and reported figures;

6. Work on internal ESG culture (in terms of risk and opportunities) and purpose of the company as well as a commitment by the entire organisation. To what extent do Internal Audit and risk management actively support the Board in monitoring the depth of change? (planning, execution, and quality of target / milestone determination and reporting).

IV - Recommendations regarding the cooperating in this new context

Pre-requisites to consider by the three respective professions:

Risk Managers, Internal Auditors, and board members should collectively question themselves without delay on current issues to address the following points:

Awareness and accountability

Reflect the Board's growing responsibilities designed to achieve sustainable objectives into structured governance processes. Include a clear accountability chain especially regarding due diligence requirements, strategy, KPIs.

Risks and opportunities at Board level

Determine sustainable risks and opportunities with senior management and define the Board's specific mandate accordingly. Continuously repeat and adapt this process as part of an ongoing strategic review, within the boundaries set by the company's risk appetite.

Practical expectations and implementation

Define concrete expectations and key duties of Internal Auditors and Risk Managers regarding their respective roles throughout the process of transition. Also, repeat this step continuously and adjust based on changes. Involve other relevant functions, notably in the domains of compliance, law, sustainability, finance, and corporate social responsibility.

Strong cooperation between the different functions is crucial to leverage all expertise and experiences while assisting the Board in fulfilling sustainability objectives.

We recommend:

- The use of a common language and lexicon regarding sustainability risks and opportunities to ensure common, coherent dialogues and to avoid misunderstanding or confusion.
- A common understanding of the different value chains (For example, what are the companies' indirect relationships?)
- A common understanding of the implications of double materiality upstream and downstream throughout all the value chains (What will be the impact for the operations and the products?)
- A clear alignment on the disclosure of the materiality assessment process and its results. Identifying the person who is responsible for concluding this assessment.
- A clear understanding of the relevant stakeholders involved in achieving sustainability objectives (Who are they? How to take their views into consideration? How to organize the dialogue among all relevant actors?)
- A corporate culture that embraces enterprise-wide risk management (ERM) is a fundamental factor in determining how organisations approach and deal with sustainability. Managing sustainability risks and opportunities requires a mature risk management function and processes.

V - Conclusion

It is important to move from the "duty to report" to the "duty to act".

Essentially, Risk Managers, Internal Auditors, and board members must complement each other's efforts throughout the process. As each of their respective roles are uniquely impactful and invaluable for companies' ability to build resilience, take advantage of opportunities from the green transition and effectively comply with sustainable standards through a holistic approach.

VI - Appendix

Moving to the next level: maturity-level self-assessment and matrix

The maturity-level self-assessment Matrix ecoDa, FERMA, and ECIIA have developed is a simplified grid of scenarios in the form of a spreadsheet that allows organisations to think through where they stand in terms of due diligence and meeting sustainability requirements.
While this tool was developed as an illustration by professional Risk Managers, Internal Auditors and Board members, it should not require any special expertise to be useful, and could be used by organisations of all sizes.

Along the vertical side of the Matrix are 13 individual criteria for analysis: Strategy, Business model, Indicators, Corporate culture, Governance, Remuneration, Organisation, Involvement of Support Functions, Internal Audit activity (3rd line), Risk Management process (2nd line), Internal Control system (where/if applicable) [2nd line], Information systems; and, External Communication.

Then, across the horizontal side of the Matrix are four different scenarios that characterise the maturity-level: Company has not started at all, Company has started think phase, Company has started build phase, Company has implemented the integrated phase.

So, taking into account the horizontal and vertical scenario and criteria, the intention behind this Matrix is to prompt organisations into assessing the maturity of their approach to sustainability in different areas.

For example, the objective should be to assess where on a scale the organisation believes itself to be positioned across a number of different areas (such as strategy, Internal Audit, etc.). The scale is illustrated below.

Company has not started at all (1)	Where no formal recognition of ESG has been made; and, for example the company communicates around ESG but it doesn't fit inside the processes, policies and operations (i.e. greenwashing)
Company has started think phase (2)	The beginning of reflection on ESG, for example there have been some brainstorming sessions and the company has considered a roadmap around ESG integration
Company has started build phase (3)	The rolling out of ESG policies and processes where ESG is implemented into operations and there are some actions related to ESG spelled-out
Company has implemented the integrated phase (4)	The company genuinely and obviously addresses ESG throughout its operations, policies, and processes → **it is mainstream.**

Here it must be stressed that our three organisations are providing a template of what we collectively consider to be basic, standard, advanced etc. based on the practical experience of the Members of the Working Group.

We recommend using this Matrix with that in mind, and customising it according to local context. It is not our aim for these to be definitive.

Below is an example of what the final result of an analysis using the matrix might look like.

Criteria / Scale	1	2	3	4
Strategy		•		
Business Model	•			
Indicators		•		
Corporate Culture			•	
Governance			•	
Remuneration			•	
Organisation		•		
Involvement of Support Functions		•		
Internal Audit Activity (3rd line)		•		
Risk Management Process (2nd line)	•			
Internal Control System (where/if applicable) [2nd line]		•		
Information Systems		•		
External Communication				•

We have intended on the Matrix being as basic and user-friendly as possible, with the idea of having a neat illustration at the end of it.

With the illustration, you can provide an at-a-glance table that shows the areas of relative strength and weaknesses.

Using the results, organisations can look at their approach to sustainability risk oversight and launch a conversation from there.

VII - About

About the European Confederation of Directors Association

The European Confederation of Directors Associations (ecoDa) is a not-for-profit association founded in December 2004 under the laws of Belgium. Through its 20 national institutes of directors (the main national institutes existing in Europe), ecoDa represents approximately 55,000 board directors from across the EU. ecoDa's member organizations represent board directors from the largest public companies to the smallest private firms, both listed and unlisted

About the European Confederation of Institutes of Internal Auditing

The European Confederation of Institutes of Internal Auditing (ECIIA) is the professional representative body of 34 national institutes of Internal Audit in the wider geographic area of Europe and the Mediterranean basin, they represent approximatively 55.000 Internal Auditors. The mission of ECIIA is to be the consolidated voice for the profession of Internal Auditing in Europe by dealing with the European Union, its Parliament and Commission and any other appropriate institutions of influence. The primary objective is to further the development of corporate governance and Internal Audit through knowledge sharing, key relationships and regulatory environment oversight.

About the Federation of European Risk Management Associations

The Federation of European Risk Management Associations brings together 22 Risk Management associations in 21 European countries, representing 5000 Risk Managers active in a wide range of business sectors from major industrial and commercial companies to financial institutions and local government bodies. FERMA provides the means of coordinating risk management and optimising the impact of its member associations at a European level.

VIII - Thank you

We thank everyone for the fruitful discussion and the contribution to this paper

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