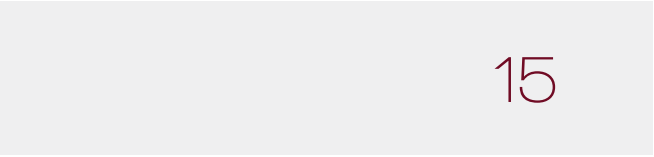
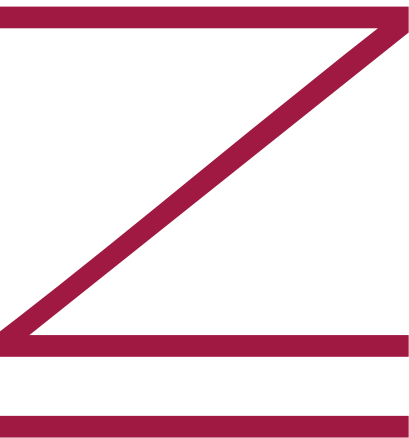


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ESG implies risks and opportunities and should be integrated into the organization's strategy





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# About Esfera Consejeros

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**Esfera Consejeros** is an initiative directed at members of the **Audit Committee**.

This service provides analysis, synthesis and knowledge from a perspective of Internal Audit **rigor, quality** and **independence**.

Our objective is to provide the **knowledge** and **transversal viewpoint** characteristic of internal auditors, and thereby contribute towards enabling board members' oversight of the complex business world and its realm of risks.

The service draws on different publications, **RiesgosClave, EnFoco and EnRuta**, which will be addressing relevant issues of business life at different levels and focus.

One aspect that sets it apart is the **Internal Auditor's perspective** with respect to the issue being analyzed: What are the key questions we need to raise? What concerns do the Internal Auditors have, and where and how do they act in order to provide assurance and comfort? All of these are questions that are relevant to the Audit Committee in its oversight and control duties.

We trust that **Esfera Consejeros** will be useful to your organization.

February 2022

If you are a board member of an organization that is a member of the Institute and would like to register at Esfera Consejeros, [please apply here](#)



# At a glance

- 1 ESG aspects must be integrated into the organization's strategy, culture and risk appetite
- 2 Oversight is a function of the board that cannot be delegated and should follow a roadmap.
- 3 Society increasingly demands challenging requirements and there is zero tolerance for certain aspects
- 4 ESG reporting is evolving, with new and increasingly demanding legal requirements
- 5 ESG criteria are entering into policies for executive bonuses linked to objectives.
- 6 Internal Audit is key in its dual role as assurance and consulting provider.

# ESG Risks: key aspects

Sustainability should be incorporated into the strategic thinking process in order to assess the extent of its relevance in fulfilling the organization's purpose and moving closer towards its vision. ESG is a transversal concept that must permeate throughout the entire organization.

The following are some of the key ESG risk issues raised in the report issued by La Fábrica de Pensamiento.

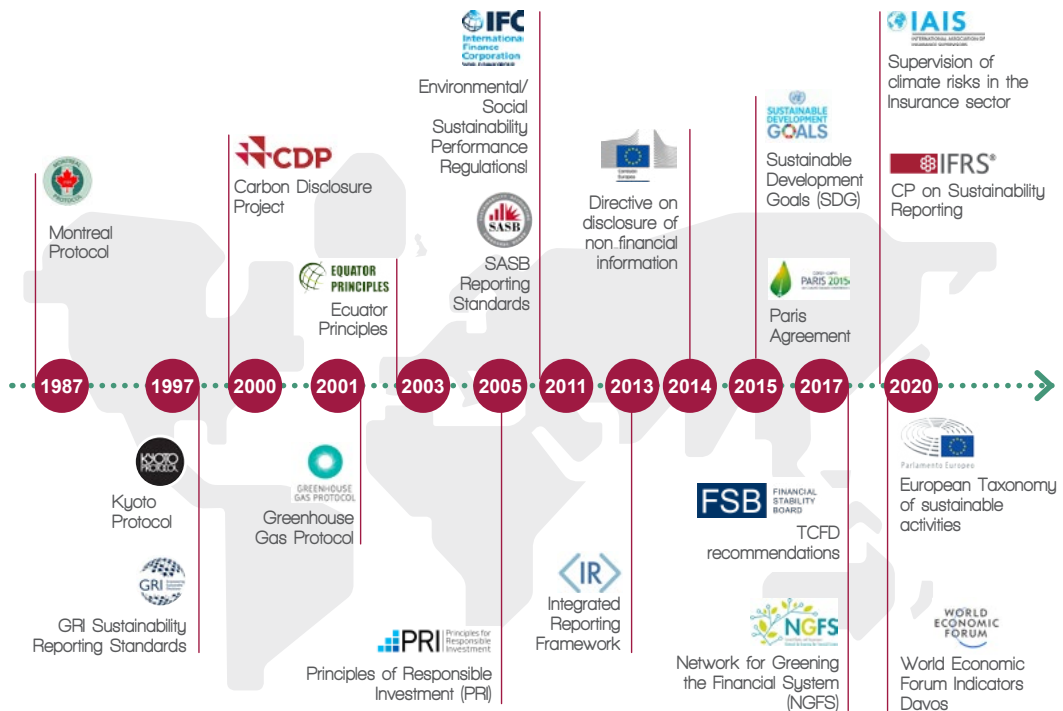
These are complex and multifaceted risks which are increasingly under scrutiny. Understanding, managing, informing and mitigating ESG risks is critical. They must predominate strategy. The role of Internal Audit is relevant for assisting in the construction of a robust control and oversight system for ESG risks.



## Strategy and governance

- Senior management is responsible for strategic management in the implementation of ESG objectives: it defines the actions to be taken and designates those responsible for carrying them out.
- The Board of Directors and its supporting committees (Audit Committee and/or Sustainability Committee) must guide, oversee and control the organization's approach to sustainability.
- It is key to ensure that ESG risks are integrated into the strategy, culture, risk appetite framework, models and Internal Audit reviews.
- Policies for variable compensation (e.g., bonuses) are increasingly linked to the achievement of ESG objectives.

## ESG: milestones and regulatory highlights



Source: Institute of Internal Auditors of Spain. La Fábrica de Pensamiento: Internal Audit and ESG criteria.

## What lies behind the three pillars



### ENVIRONMENT *Environmental\_E*

Environmental impact of the activity, such as pollution, use of resources, or the adaptation to, and mitigation of climate change

The main environmental goals (in accordance with EU Taxonomy) are:

- Climate Change:
  - Mitigation of climate change.
  - Adaptation to climate change.
- Environmental Challenges:
  - Sustainable use and protection of water and other marine resources.
  - Transition to a circular economy.
  - Pollution prevention and control.
  - Protection and restoration of biodiversity and ecosystems.



### SOCIAL *Social\_S*

Impact on society, the community, the economy and on stakeholders in general

Some of the main objectives in social terms (in accordance with the international benchmarking standard *Global Reporting Initiative*, GRI) are:

- Eradication of social inequality.
- Social inclusion.
- Improvement of labour relations.
- Investment in human capital.
- Protection of local and indigenous communities.
- Preservation of cultural heritage.



### GOVERNANCE *Governance\_G*

Include elements of sound governance in institutions, recognizing its fundamental role on shareholders, customers, employees and all those affected by business decisions

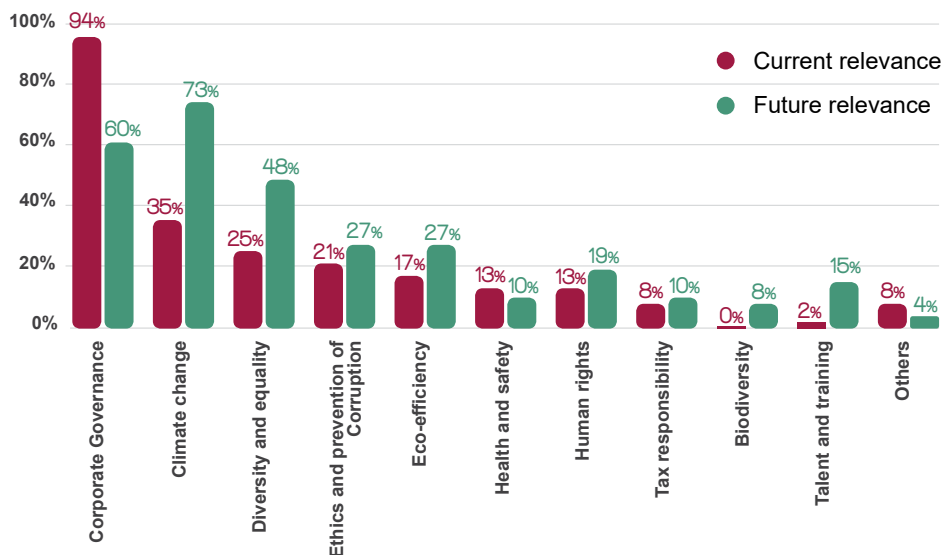
Some of the main goals in the area of sound governance (in accordance with international benchmarking standard *Global Reporting Initiative*, GRI) are:

- Developing solid structures for management, leadership and internal relations.
- Encouraging independent decision-making.
- Boosting transparency and accountability.
- Promoting good practices.
- Preventing corruption and fraud.

## Identification, evaluation and management

- With ESG, materiality is the threshold from which certain social, ethical or environmental issues are considered relevant to the organization and to its stakeholders.
- GRI standards for reporting: should reflect any significant economic, environmental and social impacts on the business and/or goals, and thereby influences stakeholder assessments and decisions.
- The best practice is to obtain a quantification of risks by modelling their frequency and impact, and aggregating them through correlation matrices.
- Society is imposing increasingly demanding minimum standards, pushing companies to anticipate and continuously adapt their risk appetite.
- With ESG aspects, there is zero tolerance for regulatory, reputational or financial impact.
- The System of Internal Control over Non-Financial Reporting (ICNFR) aims to provide confidence regarding the reliability of non-financial information.
- Internal Audit should monitor the design and effectiveness of the controls included in the ICNFR.

## What do investors ask about?



Source: KPMG, Forética and the Institute of Financial Analysts of Spain (IEAF/FEF). The importance of ESG issues. March 2020.

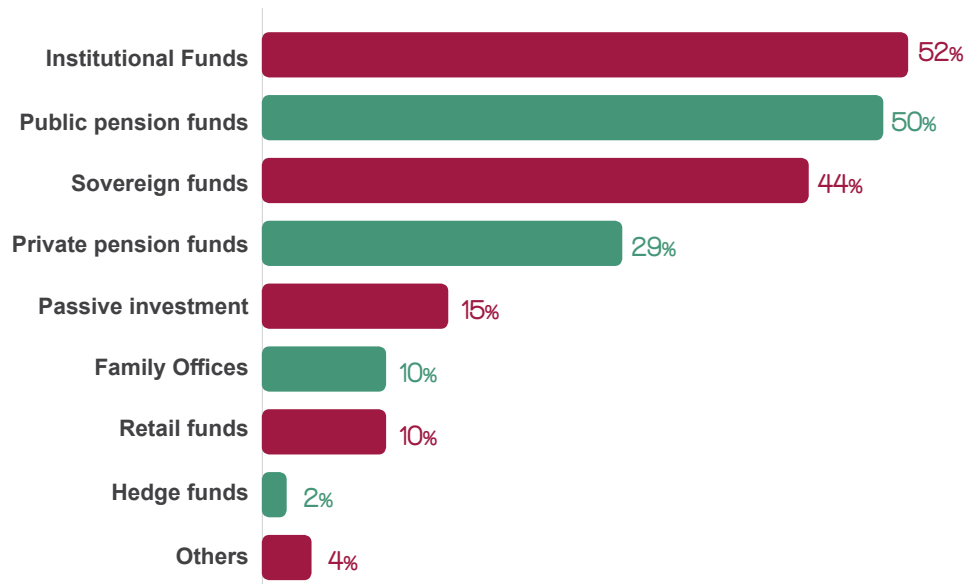


## Reporting

- ESG reporting frameworks are less mature than those for financial reporting.
- The most widely used frameworks include: GRI, SASB, IIRC, Value Reporting, UNGC, TCDF and CDSB.
- Reporting depends largely on the type and size of the company and its ESG maturity.
- Internal Audit should independently watch over the effectiveness of reporting policies covering the various roles involved.
- The ESG reporting role is an evolving function, with new and increasingly challenging legal requirements.
- The information must be verified by a qualified independent service provider.

## Investors who are most interested in ESG

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Source: KPMG, Forética and the Institute of Financial Analysts of Spain (IEAF/FEF). The importance of ESG issues. March 2020.

## Performance indicators

### EXAMPLES OF KRIs WITH DIFFERENT METHODOLOGIES (quantitative or qualitative)



#### ENVIRONMENT *Environmental\_E*

	METHODOLOGY	KRI
Climate change	Quantitative	Carbon footprint/emissions
	Quantitative	Average annual temperature/precipitation
Natural resources	Quantitative	Water Assessment
	Qualitative/Quantitative	Environmental Biodiversity
Pollution and Waste	Quantitative	Production of Raw Materials
	Quantitative	Toxic Emissions
	Quantitative	Waste



#### SOCIAL *Social\_S*

Human Capital	Quantitative	Staff Turnover/absenteeism
	Quantitative	Personnel safety/incidents
	Qualitative	Labour climate based on staff surveys (score)
	Quantitative	No. of breaches of international SDGs (Zero Tolerance)
	Quantitative	Percentage of men/women and gender pay and other gaps



#### GOVERNANCE *Governance\_G*

Governance	Quantitative	No. of policy breaches (Zero Tolerance)
	Qualitative	Concentration level of suppliers complying with policies
Ethics	Quantitative	Score obtained in ESG entities
	Quantitative	No. of whistleblower channels
	Quantitative	Accumulated incidents at call centre by type
	Qualitative	Staff Surveys (score)
	Qualitative	External Surveys image

# Questions for directors

Board members are increasingly trained and prepared on ESG issues thanks to the advice of auditors, consultants, lawyers, sustainability experts, etc., as well as the drive by stakeholders and shareholders who wish to know how companies govern ESG factors. Here we are providing a number of key questions that board members should be posing and asking themselves with regard to ESG criteria.

The board's scope is governance, not management. It should analyze the impact, commitment and expectations of stakeholders. ESG factors form part of the elements to be monitored. Board members need to be educated and informed to understand the implications of sustainability and ask the right questions.

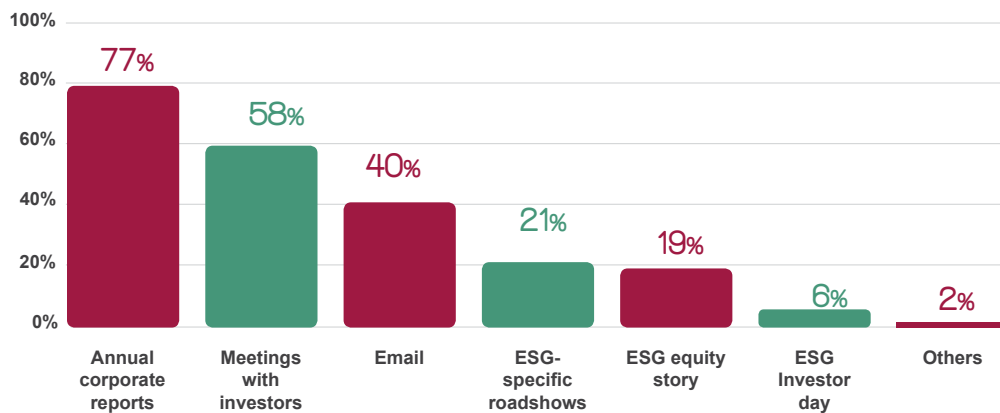


<sup>1</sup> The questions in this section have been selected from various sources: **The Institute of Internal Auditors of Australia**. The 20 Critical Questions Series What Directors should ask about ESG. (November 2020). / **Protiviti**. 10 ESG Reporting Questions Directors Should Consider (October 2020)/ **NACD**. Ten ESG Reporting Questions Directors Should Consider (October 2020)/ **Norton Rose Fulbright**. ESG: What boards of directors should do now (August 2021). / **PwC**. ESG oversight: The corporate director's guide. (November 2021).

## General questions

- Does the company have any kind of public and explicit commitment to ESG or SDGs?
- Have ESG risks and opportunities been identified and integrated into its long term strategy?
- Are ESG risks included in the Board's and the Audit Committee's agenda?
- Are the purpose and values aligned with ESG commitments and are they reflected as such?
- Are ESG commitments communicated effectively to investors and stakeholders?
- Has the organization analyzed of what competitors are doing in this respect? And rating agencies?
- Does the organization know the expectations of its stakeholders and shareholders regarding the ongoing development of ESG over time through regular dialogue?
- Are board members trained in the required skills and possess the knowledge to oversee ESG factors?
- Are staff and suppliers familiar with ESG criteria?
- Is the organization equipped with the necessary human and financial resources?
- Are executive incentive systems aligned to ESG objectives?

## How are ESG issues communicated to the market?

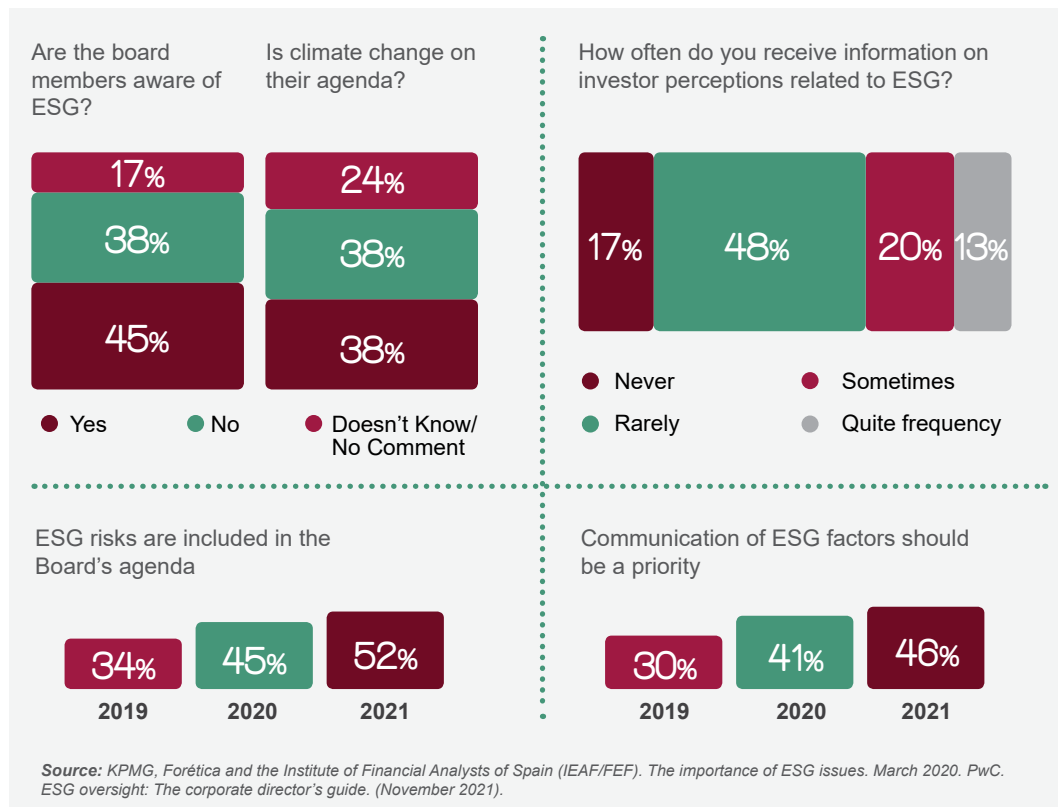


Source: KPMG, Forética and the Institute of Financial Analysts of Spain (IEAF/FEF). The importance of ESG issues. March 2020.

## Controls and reporting

- Have material ESG risks been identified and incorporated into risk management?
- Has the organization established policies and a framework of internal controls and processes to verify the completeness, consistency and comparability of ESG information and to ensure monitoring of related risks?
- Has the oversight of ESG risks been assigned to a specific committee?
- Is Internal Audit involved in assurance of ESG reporting? What is its role?
- Does the organization have a high-level management committee for sustainability?
- Is there a specific person responsible for ESG issues?

## The board and ESG risks



- Is there a robust and transparent whistleblowing process for these issues? In which channels?
- Are there specific penalties for employees or suppliers who fail to comply with ESG requirements? Are there effective applications in place?
- What reporting standards does the organization work with and why?
- Is the reporting satisfactory and sufficient for the investment community and other stakeholders?
- Has the organization considered integrating financial and ESG reporting?



#### AUDIT OF ENVIRONMENTAL ASPECTS

##### Environmental management

- Emissions not related to greenhouse gases and pollution.
- Natural resources and biodiversity management, and ecosystem services.
- Circular economy and waste management

##### Climate change

- Governance.
- Risk management process.
- Strategy.
- Objectives.

##### Environmental risks

- Environmental Analysis.

##### Climate risk

- Government.
- Risk management process.
- Strategy.
- Reporting.



#### AUDIT OF SOCIAL ASPECTS

- Diversity and equality.
- Contribution of value to society.
- Contribution via subsidies.
- Innovation.
- Recruitment and human resource management.
- Employees' health, safety and well-being.
- Training.



#### AUDIT OF GOVERNANCE ASPECTS

- Structure of governance and responsibilities.
- Stakeholders' expectations.
- Strategy, Risk Management and Investment.
- Remuneration system.
- Internal Regulatory Framework and Information Systems.
- Transparency, Supervision and Reporting.
- Ethics and Integrity.
- Bribery and corruption.
- Taxes.

## Monitoring and Internal Audit

- Has an ESG plan or roadmap been established, with objectives and metrics to monitor performance (KPIs)?
- Is there a need for independent external assurance of the integrity and reliability of non-financial information?
- Have these risks been formally assessed and action plans developed to mitigate them? Are possible reputational risks included?
- Is there an integrated approach to ESG-related assurance across the Three Lines? Does this include monitoring through assessments or audits?
- Are these ESG audits reported to senior management and the Audit Committee in a timely manner?

## Crisis and response

- Are ESG risks included in the crisis management or business continuity plan?
- Are there effective and proven processes for responding quickly? And are resources available for promptly investigating and remedying exposure and risks?
- Is there a specific protocol in place on how to deal with the media if an ESG scandal breaks out?
- Is regular monitoring in place to ensure that appropriate action is taken?
- Is there a process in place to formally escalate ESG issues to the Board and/or the Audit Committee?
- How do the Board of Directors and the Audit Committee determine and be confident that ESG risks are being managed effectively and that legal and regulatory obligations are being met?

## Key question

**How do the Board of Directors and the Audit Committee determine and be confident that ESG risks are being managed effectively and that legal and regulatory obligations are being met?**

# Internal Auditor's perspective

## Key questions

The following are some of the most relevant **key questions** that members of the Board and Audit Committee need to ask.





## Internal Auditor Functions

The **role** of Internal Audit, in providing both assurance and consulting services, is highly relevant towards creating real value for risk management and control, and for identifying opportunities associated with ESG factors.

To perform its role, Internal Audit needs to understand and analyze certain general issues: oversight of ESG issues by governance bodies and senior management; identification, assessment and management of ESG risks and opportunities; degree

of implementation of the ICNFR and the reporting framework in place. This also involves detecting specific risks for each material issue, within each of the three ESG pillars, and establishing a specific approach.

### Environmental aspects (E).

Highly diverse. They may require experts for addressing certain issues. Two categories: environmental management and climate change, which may generate reputational, operational regulatory or financial risks.



### Social aspects (S).

The focus is on diversity and equality, the contribution of value to society, recruitment and human resource management, health, safety, training and well-being of employees, as well as product and other customer-related aspects. The main risks are related to reputation, talent attraction, human rights vulnerability, and financial



losses due to lack of innovation. The internal auditor can assess objectively auditable quantitative controls and indicators.



### Governance Aspects (G).

Main risk: non-compliance with corporate governance (structure and responsibilities of governance bodies), stakeholder expectations, or with corruption and bribery regulations (ethical aspects). The Internal Auditor can focus on testing for adequacy/effectiveness of controls.

**References: relevant regulations and documents.****- Institute of Internal Auditors**

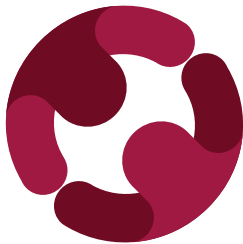
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