INTERNAL AUDIT ENVIRONMENTAL, SOCIAL, AND GOVERNANCE RISK COVERAGE PRIORITIZATION

The implementation of additional SEC ESG-related disclosure will likely increase internal audit resource utilization, but in the medium term, it may enable greater automation due to increased management and compliance process rigor.

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Internal audit has an expansive remit that traditionally covers any organizational activity relevant to the board of directors. Common internal audit coverage areas include financial management, operational execution, and corporate governance (e.g., U.S. Sarbanes–Oxley Act compliance). Every organization's instantiation of internal audit is bespoken to their situation and resources. New topics frequently enter internal audit's mandate when they emerge as potentially material or regulated.

Corporate sustainability risks under the banner of environmental, social, and governance (ESG) are a growing risk category gaining both materiality and regulation. Exhibit 1 illustrates the wide variety of topics that fall under ESG. ESG risks that are financially material are included in SEC disclosure requirements for publicly listed companies. SEC disclosure information and risks are already assured by internal and external audits. However, as Exhibit 1 shows and The Institute of Internal Auditors reports, this still leaves a large area of ESG risks outside of any external audit and available for internal audit to prioritize for attention.[1]

Recent SEC ESG-related disclosure updates

The SEC has recently added and proposed additional ESG risk disclosures that affect internal audit prioritization. The SEC Mod-

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EXHIBIT 1
ESG Risks

Note: Dummy data used for illustrative purposes.

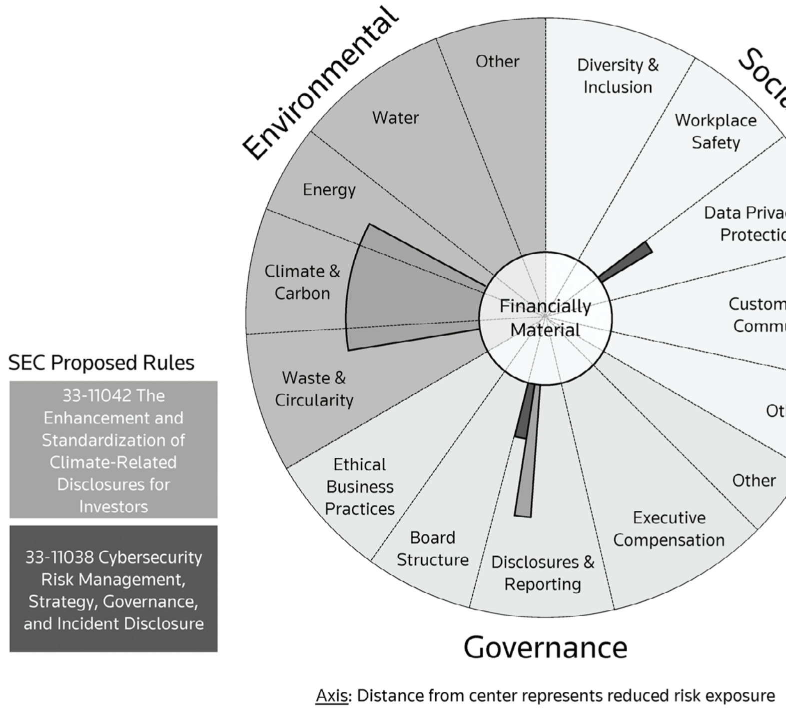
ernization of Regulation S-K Items 101, 103, and 105 rule added additional human capital disclosures to the extent that they are "material to an understanding of the registrant's business."[2] This is in keeping with the longstanding SEC position that materiality is not a simple quantitative measure.[3] To the extent that this rule increased SEC S-K disclosure, it also increased external audit coverage and internal audit priority of this topic.

Two currently proposed rules — SEC Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, along with SEC Enhancement and Standardization of Climate-related Disclosures for Investors — not only reference risks that are reasonably likely to have a material impact, but they also provide additional information relevant to risk decision-making regardless of materiality.[4] Specifically, the former would require cybersecurity incident reporting, and the latter would require greenhouse gas emissions reporting. If these rules are implemented, they will increase external audit coverage and internal audit priority of this topic beyond the current levels reported in Roberts et al.[5]

In addition to rule changes, the SEC has modified enforcement of ESG-related disclosures. Peters analyzed the intent of SEC comment letters to companies before and after the updated guidance on climate change disclosures from the SEC Division of Corporate Finance.[6] Before September 2021, enforcement focused on missing information. After September 2021, enforcement focused on inaccurate reporting.

Exhibit 2 shows the potential impact of proposed SEC rules on the depth of risk disclosure coverage. Risk categories across all three ESG areas are impacted. Organizations will develop additional management and compliance activities to ensure accuracy. For example, some organizations will likely adopt the World Resources Institute greenhouse gas protocol to standardize reporting.[7]

EXHIBIT 2
ESG Risk SEC Disclosure Coverage



Note: Dummy data used for illustrative purposes.

Internal audit ESG-related risk coverage prioritization

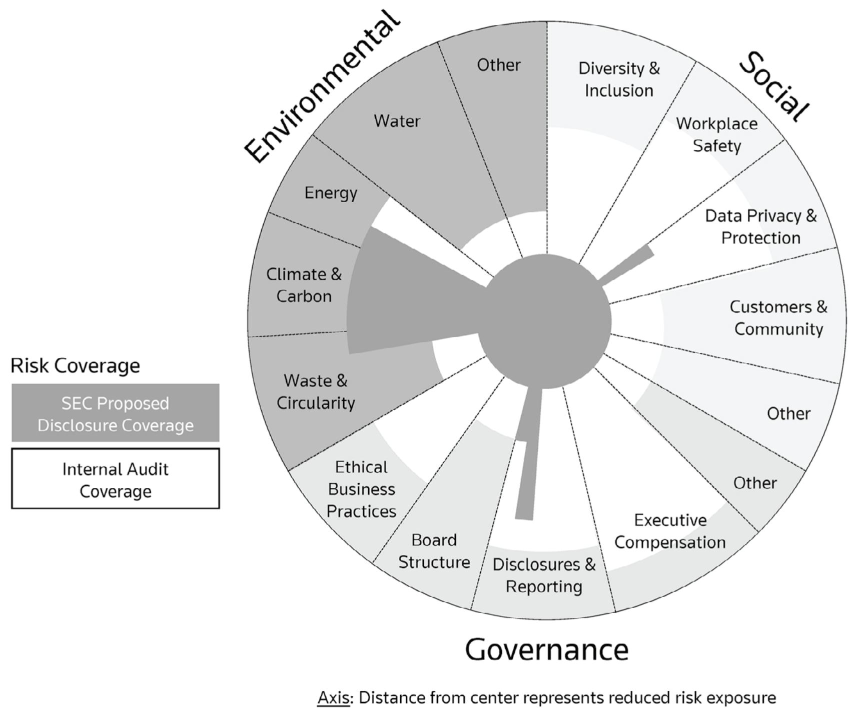
Impact from SEC ESG-related disclosure updates. Internal audit's impact from updated SEC ESG-related disclosures is not as clearly defined as that of external audit. While external audit will now extend coverage to the new disclosure areas, internal audit will have a variable impact, depending on how much of the new disclosure area was already covered. In addition, as mandatory SEC disclosure is extended, the efficacy of organizational management, processes, and governance increases. This more rigorous management and external auditing may allow for more efficient and automated internal auditing over these risk areas.

Internal audit coverage will likely increase due to the proposed SEC ESG-related disclosures. However, in the medium term, it may allow internal audit to reduce human resources in these areas and use them to extend coverage in newly emerging areas. For instance, the Internal Audit Foundation recommends screening opportunities for robotic process automation by identifying "processes that are standardized."[8]

Impact from sustainability materiality assessment. An important input to internal audit's ESG-related risk coverage is the organization's sustainability materiality assessment. Sustainability materiality is not synonymous with financial materiality. Rather, sustainability material issues are important to the very long-term holistic health of the organization. They include wider impacts to the environment and society that may not have current financial costs. A potential method of linking these two concepts is double materiality, as described by Geiger in relation to space sustainability.[9] These issues may be financially material as well. To avoid confusion between the financial and sustainability materiality terms, Lockheed Martin uses the nomenclature "sustainability core issues assessment."[10]

Organizations that conduct sustainability materiality assessments, and then act and report on them, likely institute related man-

EXHIBIT 3
ESG Risk Internal Audit Coverage



Note: Dummy data used for illustrative purposes.

agement and governance processes. For instance, Peters and Romi reported that organizations with increased sustainability governance tended to have increased external sustainability data verification.[11] Although these processes may not be as robust as those related to SEC disclosure, they are a prime target for internal audit coverage and automation. Exhibit 3 illustrates an example of ESG risk internal audit coverage in relation to the SEC's proposed disclosure coverage. This article proposes prioritizing, measuring, and reporting internal audit ESG risk coverage as a ratio of SEC disclosure coverage. The Honoria Ratio is defined as internal audit coverage/SEC disclosure coverage in an ESG risk category or subcategory. For instance, in Exhibit 3, the climate and carbon Honoria Ratio is 1, because internal audit covers no additional risk exposure beyond SEC disclosure coverage; meanwhile, the water Honoria Ratio is 1.75, because internal audit covers an additional 75 percent more risk exposure than SEC disclosure coverage. This ratio approach lends itself to either quantitative or qualitative risk assessment techniques. Also, as financial materiality can be applied to any risk, it can be used as the basis for any ESG risk category ratio.

Additional risk ratio analysis can be conducted between internal audit and other risk-informed functions such as sustainability and business resilience. In each case, areas of more defined processes are ripe for internal audit automation if coverage is warranted. This allows internal audit personnel to focus on more complex and ill-defined areas of risk to the organization.

Organizational differences. Every organization has different thresholds for financial materiality, internal audit coverage, and sustainability materiality. Sustainability disclosure standards often have different requirements for different parts of the economy. For instance, the Sustainability Accounting Standards Board has 77 different industry standards that customize the type of data reported by companies, and the Global Sustainability Standards Board Global Reporting Initiative standard is customizable with both required and optional data fields.[12] As the Financial Accounting Standards Board and IFRS International Sustainability Standards Board determines global sustainability-related disclosure standards for publicly listed companies, there is the possibility that an industry-customized approach may become required for listed companies. In this event, the regulatorily required coverage area in Exhibit 3 would be unique by industry. However, this would not affect the scope of financially material risks.

Conclusion

The implementation of additional SEC ESG-related disclosure will likely increase internal audit resource utilization in these areas, but in the medium term, it may enable greater automation due to increased management and compliance process rigor. The Center for Audit Quality S&P 500 and ESG reporting publication found that 95 percent of S&P 500 companies publicly divulged ESG information, while only 53 percent of them received external assurance for the information.[13] With the proposed move from voluntary to obligated external ESG data assurance, internal audit departments may be able to increase coverage into more complex areas of ESG risk using SEC disclosure coverage ratio-based prioritization. ■

NOTES

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3 "SEC staff accounting bulletin: No. 99 — Materiality," U.S. Securities and Exchange Commission (Aug 12, 1999). Available at: https://www.sec.gov/interps/account/sab99.htm.

4 "Cybersecurity risk management, strategy, governance, and incident disclosure," U.S. Securities and Exchange Commission (Mar 23, 2022). Available at: https://www.federalregister.gov/documents/2022/03/23/2022-05480/cybersecurity-risk-management-strategy-governance-and-incident-disclosure; "The enhancement and standardization of climate-related disclosures for investors," U.S. Securities and Exchange Commission (Apr 11, 2022). Available at: https://www.federalregister.gov/documents/2022/04/11/2022-06342/the-enhancement-and-standardization-of-climate-related-disclosures-for-investors.

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