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Internal Controls for Sustainability Reporting Using COSO

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With the recent rapid changes taking place, corporate reporting – which was once focused on financial reporting – is now in process of incorporating sustainability reporting, which includes environmental, social and governance matters. While companies had long reported on sustainability, it was focused on informing the general public rather than on investors and their needs. A cynic would say it was often focused on public relations. The move to reporting on sustainability matters of concern to investors was a major shift and was supported by regulators such as the SEC. This is likely to lead to the next step – integrated reporting, under which financial and sustainability reporting are combined and events and issues reported with a full coverage of their implications for both fields of reporting, a product of integrated thinking, that companies are being encouraged to embrace.

Bring in the Auditors?

While not yet required, another next step would be to have the new reports accompanied by assurance reports, either audited or with lesser levels of assurance. Standards need to be developed for this stage to be reached. As well, internal controls over sustainability reporting need to be defined and implemented before assurance can be provided.

Internal controls have long been a requirement for protecting and preserving the integrity and quality of business information. Initially, their chief application was for numerical financial information but, gradually, they increased in scope to include narrative information because there is a lot of narrative in financial reporting, particularly in notes to the financial statements and documents such as the MD&A.

More recently, large companies listed with the SEC have been required to report on the controls in place over their financial reporting process. They are also required to obtain an audit opinion on these controls. And so, the idea of controls over financial reporting has become a very important subset of internal controls generally.

While the advent of assurance on sustainability information may be a few years away, good internal controls are essential to the provision of high-quality, reliable information. So, companies are seeking ways to develop internal controls over sustainability information.

Traditionally, internal controls over financial reporting have been managed in the corporate finance area. At the same time, sustainability reporting has largely been organized under a company's PR and Admin areas. That meant that companies wanting to develop good reliable sustainability information have been looking to bring together their various departments to capitalize on the established expertise that finance has built in developing and administering relevant internal controls.

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COSO Gets Involved
The most common set of standards used for establishing and reporting on internal controls was that issued by The Committee of Sponsoring Organizations of the Treadway Commission (COSO), which published its Internal Control—Integrated Framework (the Framework) in 1992 to provide guidance on the controls appropriate for (mostly) financial reporting. It was then updated and expanded in 2013 to include certain guiding principles.

In the 2013 expansion, the committee said "The Framework has been enhanced by expanding the financial reporting category of objectives to include other important forms of reporting, such as non-financial and internal reporting." In the view of many people, this reference to non-financial opened the door for sustainability reporting.

The COSO framework sets out internal control objectives in three categories:

a. **Operations** objectives, which include performance goals and security over company assets, and focus on the effectiveness and efficiency of business operations.
b. **Reporting** objectives related to both internal and external financial and non - financial reporting, and focus on transparency, timeliness and reliability of the organization's reporting processes.
c. **Compliance** objectives, which focus on adherence to laws and regulations with which the organization must comply.

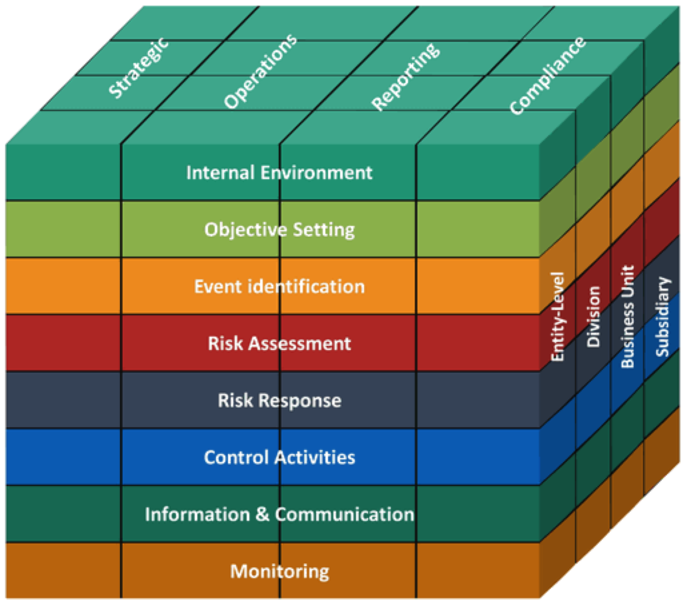
The framework sets out five components to an internal control system, as follows:

1. **Control environment:** the "set of standards, processes, and structures that provide the basis for carrying out internal controls across the organization." This component includes: Ethical values, Organizational structure, Commitment to employing competent employees and Human resources policies.
2. **Risk assessment**: the organization's analysis of the risks posed by internal and external changes, the ability to establish suitable objectives for the business and the process for weighing perceived risks against risk tolerances.
3. **Control activities:** the tasks and activities involved in operating the internal controls, including such actions as "authorizations, verifications, reconciliations, and business performance reviews."
4. **Information and communication:** relevant and high-quality information to control functions. These include internal messages emphasizing the importance of control responsibilities, and external messages providing clear communication of expectations with external parties.

5. **Monitoring**: ongoing evaluations of internal controls built into business processes, as well as regular separate evaluations, which will vary based on level of risk, system effectiveness and regulatory requirements.

These objectives and components are illustrated in the COSO Cube included in the Framework, which is shown below. It also illustrates various organizational levels at which the Framework can be implemented.

COSO (CUBE) FRAMEWORK



Application of COSO to Sustainability Reporting

For several years, a great many companies have produced ESG (Environmental, Social and Governance) Reports. In those reports, companies provide information on the impact their activities are having on the environment and the steps they are taking to reduce their negative impact. Mitigative activities, such as reforestation, carbon emissions control and water discharge control, are often featured. The negative impacts are often downplayed.

In more recent standards, the emphasis has shifted to the idea of value creation. For example, "The SASB defines sustainability in the broader context of an organization's capacity and capability for longer-term value creation across a variety of dimensions, including:

- Environment
- Social capital
- Human capital
- Business model and innovation
- Leadership and governance"[1]

As can be seen, not only did modern standards shift to value creation, the SASB also expanded the scope of ESG reporting to include human capital separately, as well as the business model and innovation idea. Arguably, these additional items would have been included in ESG anyway, but the SASB standards do add additional focus on them.

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[1] Robert H. Herz, Brad J. Monterio and Jeffrey C. Thomson, *Leveraging the COSO Internal Control—Integrated Framework to Improve Confidence in Sustainability Performance Data,* September 2017.

organization's capacity and capability for longer-term value creation across a variety of dimensions.

When one applies COSO to sustainability reporting, recognizing that COSO has largely been used for financial reporting, it is necessary to consider how sustainability reporting differs from financial reporting. Sustainability reporting has several characteristics that are different from financial reporting. Here are a few:

1. The subject matter of the two types of reporting is very different. Financial reporting centers around the traditional financial statements and measures of financial operating results and financial position. Sustainability reporting includes the type of reporting mentioned above – environmental matters, etc.
2. Financial reporting has been the core of reporting to investors and creditors for centuries. Sustainability reporting has existed only for a few decades, and has not traditionally been directed to investors,
3. Financial reporting is primarily numbers based, although the amount of text included in it has grown tremendously in recent years. Sustainability reporting has been largely text, with the use of some metrics. The new emerging standards will encourage the use of more metrics.
4. Financial reporting includes some future-oriented information. Sustainability reporting often includes much more.
5. Financial information is generated from relatively closed and well-established systems with built-in controls. Sustainability information comes from a variety of sources, often with little or no controls built in.

In applying COSO to sustainability reporting, all the COSO objectives would apply. The five components would need to be addressed in the context of the sustainability information streams, which would need to be identified and documented.

The **Control environment** can be evaluated by reviewing the ethical values, organizational structure, commitment to employing competent employees and human resources policies. Since the control environment for sustainability is not as well established and rigorous, areas for enhancement should be identified and acted upon. **Risk assessment** involves identifying what the risks are and what the tolerance for misstatement would be for the company. In financial reporting, materiality plays an important role in assessing potential misstatements. Relatively concrete guidelines exist for measuring materiality, such as percentage of net income. For sustainability reporting, because the information is largely non-numerical, such guidelines are not available. The general definition of materiality has, however, always been based on the idea that any misstatement is material if it is likely to influence the decisions of the readers. That same basis would apply to sustainability. But the measurement is more judgmental.

When reporting evolves into integrated reporting, the integration of finance and the relevant non-financial areas will be more complete.

It is in the area of **Control activities** where the most active change needs to take place to apply

COSO to sustainability reporting. Actions such as authorizations, verifications, reconciliations and business performance reviews would need to be specifically applied to the identified sustainability information streams. In addition, under the **Information and communication** category, relevant and high-quality information would be directed to control functions, including internal messages emphasizing the importance of control responsibilities, and external messages providing clear communication of expectations with external parties. As with financial controls, **Monitoring**, including evaluations of internal controls built into business processes, is critical for the ongoing effectiveness of controls.

Application of COSO to Integrated Reporting

"An integrated report is a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and long term."[2]

When reporting evolves into integrated reporting, the integration of finance and the relevant non-financial areas will be more complete. Essentially, the concept of integrated thinking will, if successfully implemented, strive to ensure that all of an organization's efforts to create value will be taken into account in reporting, not just financial value.

Introduction of integrated reporting adds additional focus to applying COSO to financial and sustainability reporting processes because the two sets of processes would be expected to become much more integrated. Along with this level of integration is the idea of integrated thinking, which involves considering all of a company's activities in terms of how they have an impact on its sustainability as well as financial welfare. For example, if a company establishes a factory on the shore of a bay, it would report on the costs of establishing and running the new facility as well as its financial results, but it would also report on the impact of the new factory on the atmosphere, the water and the soil. It would report on matters such as ocean levels and their expected impact on the factory, as this is indeed the essence of sustainability. No more would they report on the financial impacts in one place and the other impacts in another report located someplace else.

Combining Controls and Information Flows

The idea of combining controls and information flows on an integrated basis poses new issues. The objectives of the controls would be restructured to reflect all the various value indicators. But the implementation of controls is always influenced by the nature of the information flows being managed. As previously noted, the information flows for sustainability information tends to be much more often in narrative form than financial information flows. This poses a problem in that narrative is notoriously difficult to work with.

Many people feel that bringing together these flows would be expedited by having them done on a structured basis, such as by using XBRL.

At the reporting level, the US Securities and Exchange Commission (SEC) recently provided support for this idea. At a recent open meeting, the (SEC) put forward landmark new rules on

[2] *The Role of Internal Audit in Non-financial and Integrated Reporting* (London: Chartered Institute of Internal Auditors), July, 2015.

mandatory climate-related disclosures, in proposals described by SEC Chair Gary Gensler as "driven by the needs of investors and issuers." XBRL US noted that "we are pleased to see that (as expected) these new disclosures would need to be tagged in a structured, machine-readable data language – namely Inline XBRL." The digital tagging requirement would extend not only to quantitative facts but also narrative disclosures.[3]

A study by EY found that, while two-thirds of global investors evaluate non-financial disclosures, only half of this group use a structured process to make their assessments.[4] With integrated reporting, it is much more feasible to use structured techniques.

There is much work to be done before the use of XBRL can be a reality for disclosures on an integrated basis. While taxonomies exist for financial reporting, and some for sustainability reporting, there are none that are fully integrated. *Ad hoc* solutions are possible, but comparability and quality require that the taxonomies be developed through rigorous programs by recognized bodies. The SEC and FASB need to work together as do EFRAG, ISSB and others for Europe. Other parts of the world have similar issues. So, the road to full integration of structured data may be a long one.

In the meantime, COSO is adaptable to controls over integrated reporting because it has long been used for financial and non-financial reporting and, as a working vehicle for establishing and monitoring controls, should stand up very well.

Other References:

1. *Transition to Integrated Reporting* (London: Value Reporting Foundation), September 2021.
2. *ESG Integration Insights* (San Francisco: Sustainability Accounting Standards Board), February 2021.
3. *Closing the gap: The role of integrated reporting in communicating a company's value creation to investors* (London: The International Integrated Reporting Council (IIRC), Kirchkoff), Nov 2020
4. *Integrated Thinking: A Virtuous Loop* (London: Value Reporting Foundation). DATE?
5. *The International IR Framework* (London: The International Integrated Reporting Council), January 2021.
6. Nick Main and Eric Hespenheide, "Integrated Reporting: The New Big Picture" *Deloitte Review 2012*, Issue 10.

[3] XBRL.org Newsletter, "SEC proposes digital climate disclosures in Inline XBRL**."** Posted on March 25, 2022.

[4] Tomorrow's investment rules – global survey of institutional investors on non-financial performance, EY, 2014.

and academics in Canada, the US, Australia, India, Brazil, Mexico and various European countries.

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