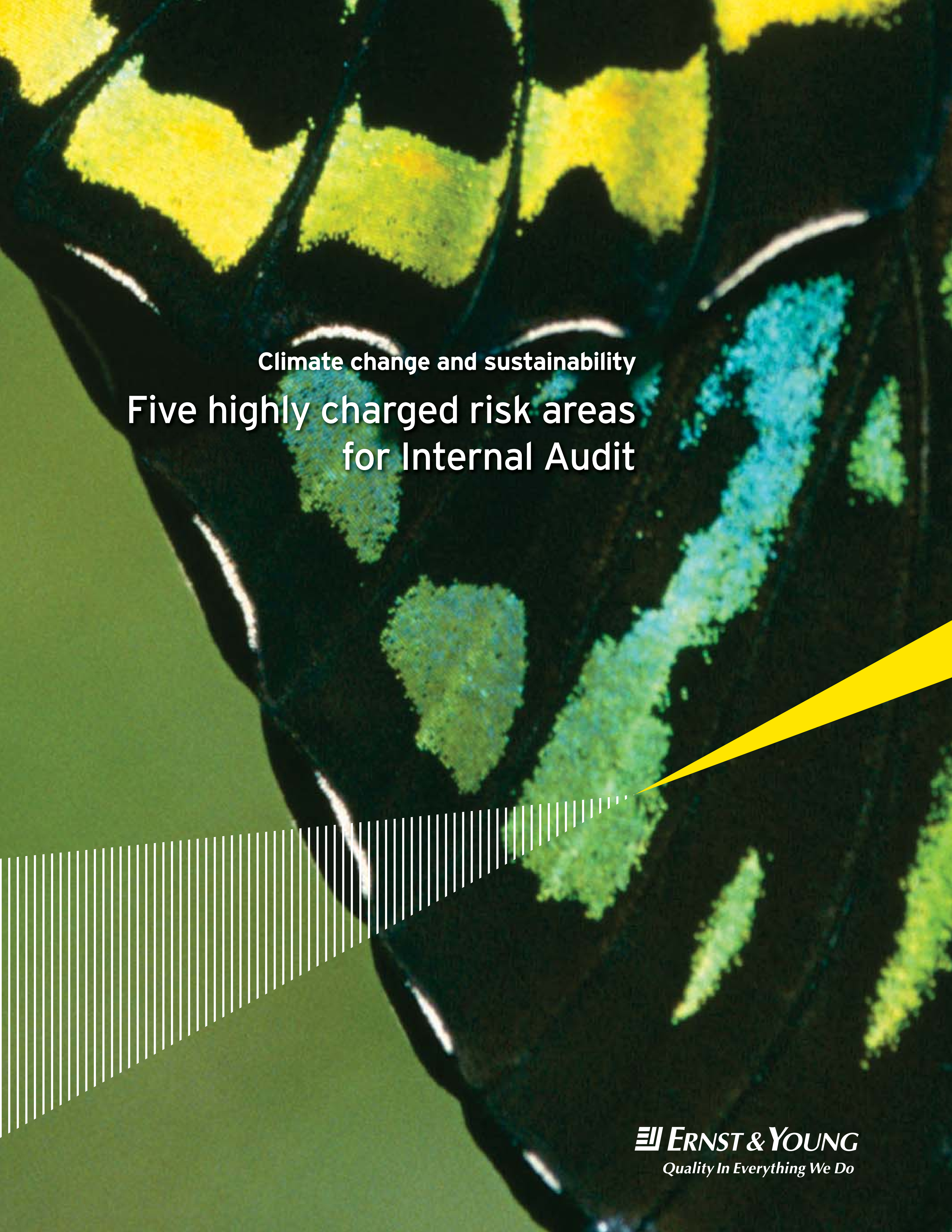


Climate change and sustainability

Five highly charged risk areas for Internal Audit

Ernst & Young
Quality In Everything We Do

Climate change and sustainability are fundamental business issues in the emerging low-carbon economy. This opens up not only new opportunities for organizations to increase revenue and reduce costs, but also the need to manage a wide variety of new risks. For the Internal Audit function, identifying and understanding these risks and how they affect the organization is critical — as is Internal Audit's role in helping to evaluate the results of climate change and sustainability initiatives and reporting when the results do not meet the company's objectives.

Accuracy in monitoring, measuring and reporting the results of climate change actions is becoming increasingly important to internal and external stakeholders. As a result, the evaluation of management's climate change and environmental agenda and disclosures is a topic of wide-ranging discussion for the disclosure committee, the audit committee and the board of directors.

Why now?

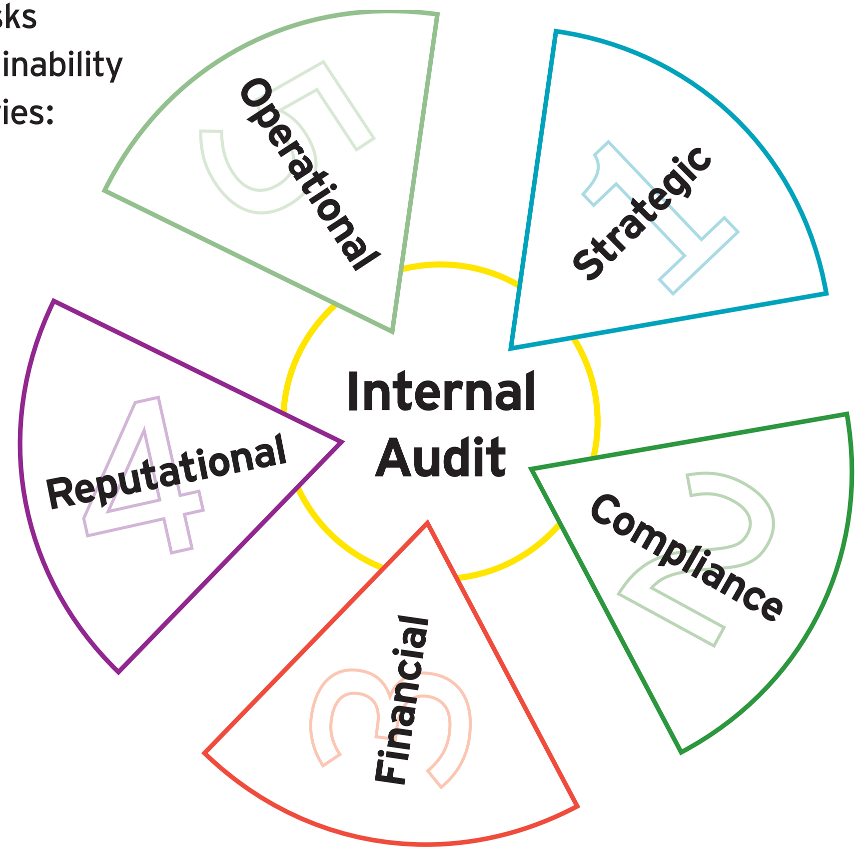
A number of forces have combined to increase interest in climate change and sustainability-related issues, including:

- Better public access to information, improved media coverage of issues and greater expectations of corporate transparency
- High-profile incidents in the workplace, including major spills, process safety incidents and human rights allegations
- Shifting consumer expectations and behavior
- Business partner expectations and competitor activities — market conditions require that companies keep up the pace in this area
- The introduction of more stringent regulations, including non-financial reporting requirements (e.g., EPA, FTC)
- Greater engagement by the investment community, including the publication and popularity of international indices (e.g., Dow Jones Sustainability Indexes)
- Employee expectations — workers increasingly say that it is important that their employer is "responsible" to society and the environment

Five categories of risk

Internal Audit can best understand the risks associated with climate change and sustainability by dividing them into five general categories:

1. Strategic
2. Compliance
3. Financial
4. Reputational
5. Operational



1. Strategic

Companies face a myriad of strategic climate change and sustainability risks, such as market positioning, changing consumer preferences, strategic investments (e.g., in cleantech and renewable energy) and stakeholder communications/investor relations, given that companies are now being valued based on their climate change performance. However, companies should not just focus on what could go wrong. Senior management and the board should be asking: "Where do climate change and sustainability risk indicate opportunities for competitive advantage?" Producing new green products or entering into new markets carries risks with it, but some companies may be better equipped to manage those risks and capitalize on them to gain competitive advantage. In other words, risk management is intimately tied to overall corporate strategy. Leading companies understand this link and are finding ways to turn climate change risks into opportunities.

What this means for Internal Audit

Internal Audit needs to have a seat at the table when climate change and sustainability strategies are being determined. This will ensure that key risks are identified and prioritized and are a recognized part of the Internal Audit plan and overall risk management (i.e., climate change and sustainability-related risks are incorporated into the organization's risk register).

An organization's entire sustainability program needs to be audited to ascertain that the program is not only meeting all established goals and targets, but also voluntary commitments (e.g., the United Nations Global Compact, or the US Climate Action Partnership).

Questions Internal Audit should ask

- Has management discussed with the board the importance of a climate change and sustainability strategy to the company?
- Does the organization fully grasp the strategic implications of climate change risk to the organization and are enterprise-wide programs in place to define, monitor and assess those risks?
- Does the Internal Audit team have the necessary skills and people to evaluate these new risks?
- Are climate change and sustainability risks captured in the company's enterprise-wide risk-assessment process?

2. Compliance

Many companies are facing new and expanding regulatory compliance risks resulting from an increasing number of international, national and regional programs. In a recent Ernst & Young study,[1] of 300 global executives from organizations with revenues of US$1b or more, 94% of respondents see national policies as important or very important in shaping their climate change strategies, although 81% recognize the importance of global or international policies. In the past year alone, over 250 climate change-related government actions were implemented globally — including state and provincial action across North America. In the US, for instance, the Environmental Protection Agency declared carbon dioxide a danger to human health and announced that it would require reporting of greenhouse gas emissions starting in 2010 for heavy emitters — on a per-facility basis. As another example, the Federal Trade Commission has indicated its intentions to crack down on "greenwashing" in marketing claims (i.e., misleading consumers and stakeholders about environmental claims). This not only opens up new regulatory compliance risks for companies, but also reputational ones, given that specific facilities will be under the microscope.

The key risk areas resulting directly or indirectly from regulatory measures are varied and can include health and safety, human rights and labor laws, anti-bribery, and environmental risks. Environmental risks can include direct impacts (e.g., emissions trading cost exposures) and indirect

1 *Action amid uncertainty: the business response to climate change*, Ernst & Young, 2010.

impacts (e.g., energy price increases and accompanying reporting and compliance costs). Audit and verification activities will also be required under certain programs, resulting in additional cost exposures. Companies in unregulated jurisdictions face additional risks around policy uncertainty.

In the US, the SEC recently provided public companies with interpretive guidance on existing SEC disclosure requirements. The SEC's interpretive guidance highlights the following areas as examples of where climate change may trigger disclosure requirements:

- **Effects of legislation and regulation.** When assessing potential disclosure obligations, a company should consider whether the effect of certain existing laws and regulations regarding climate change is material. In certain circumstances, a company should also evaluate the potential effect of pending legislation and regulation.
- **Effect of international accords.** A company should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change.
- **Indirect consequences of regulation or business trends.** Legal, technological, political and scientific developments regarding climate change may create new opportunities or risks for companies.
- **Physical effects of climate change.** Companies also should evaluate, for disclosure purposes, the actual and potential material effects of environmental matters on their business.

What this means for Internal Audit

Internal Audit needs to demonstrate to management the importance of the issues and the identification and management of the potential risks. More than ever, boards need to have confidence in the processes that are in place to manage climate change and sustainability-related risk. Internal Audit also needs to provide assurance that the organization is meeting its compliance obligations in all of the jurisdictions in which it operates (e.g., EPA regulations, such state and provincial actions as California's AB 32 or Alberta's Specified Gas Emitter Legislation). Internal Audit also needs to monitor and assess the impact of existing and proposed legislation.

Questions Internal Audit should ask

- Does the company have the business processes in place to identify and monitor the regulatory mandates concerning the environment, health and safety, community development and ethical behavior?
- Are the company's climate change and sustainability risks objectively reflected in both the internal and public reporting?
- Are processes in place to enable the company to capture all the available tax and non-tax incentives related to its climate change capital spend?
- Does the organization fully understand climate change regulation in every jurisdiction in which it operates?
- How is the organization managing risk where policy and regulation are not clearly defined?
- Does the board or audit committee have appropriate oversight over climate change and sustainability external reporting and disclosures?
- Is the board confident that management has a clear understanding of the regulatory initiatives that are under way?
- Does the board understand how these could affect the company's risk profile?

3. Financial

Increasingly, the CFO has an important seat at the table in terms of creating and driving climate change and sustainability strategy. These issues are directly and indirectly affecting share price value through issues such as new compliance costs, corporate rankings by analysts based on sustainability performance and new marketplace risks. Those include potential loss of customers and market share if a company does not adequately respond to climate change risks and opportunities.

As a price for carbon is set in varying jurisdictions, emerging compliance obligations to reduce emissions will have cash management and liquidity implications. In addition, carbon-intensive sectors may face an increase in the cost of capital as financial institutions begin to factor carbon into their lending procedures. New regulations, rapidly evolving technologies and changing customer preferences are all contributing to stresses on shareholder value. Combined, these issues are affecting how companies are valued. They are becoming increasingly important in the due diligence of proposed merger and acquisition deals.

Another critical CFO issue revolves around external reporting. Investor groups are putting more pressure on companies to report transparently on climate change and sustainability performance. Shareholder actions on this subject were up 40% in 2009.[2] These actions are expected to increase as a result of the October 2009 SEC guidance allowing shareholder actions on environmental and health topics. As the external stakeholders increase this pressure, companies need to have the systems and processes in place to collect the data to respond. Decisions need to be made as to what information should be disclosed in the annual report and what information will be disclosed in reports outside of the registration statements. All of this leads to audit committees increasingly needing to know that the information reported across multiple formats is robust, accurate and complete. Transparent reporting is also a critical element of controlling reputational risk (see pages 7-8).

What this means for Internal Audit

A substantial majority (70%) of the global executives surveyed in *Action amid uncertainty* plan to increase their climate change spend between 2010 and 2012.[3] Nearly 50% say that they will spend 0.5% of their revenue, with some planning to spend more than 5% of their revenue on climate change initiatives. With revenues of US$1b or more, at a minimum, this represents anticipated spends of US$5m to US$50m annually.

For Internal Audit, this means that there will be an increasing need for robust controls as organizations focus on reducing costs, generating new revenue streams and reducing risk. The study further reveals that priorities reflect a mix of short- and medium-term business goals, including:

- 82% of executives plan to spend on energy efficiency
- 65% have plans to invest in the development of new products and services
- 64% now report greenhouse gas emissions data in annual reports

Questions Internal Audit should ask

- What management systems and internal controls are in place to identify, monitor and quantify the risks and opportunities of climate change and sustainability-related issues?
- Does the organization have robust fiscal controls to manage this fast-growing spend?
- What effect will emerging compliance obligations to reduce emissions have on cash management and liquidity?
- Has the organization decided on what is material for non-financial reporting purposes?
- Are key performance indicators (KPIs) and the assignment of risk responsibility clearly defined?

2 Ceres, 4 March 2010. http://www.ceres.org//Page.aspx?pid=428

3 *Action amid uncertainty: the business response to climate change*, Ernst & Young, 2010.

4. Reputational

One of the key drivers that many companies face is managing the expectations of a range of stakeholders to reduce risk — including investors, employees, customers, suppliers, local communities and the media. Analysts are also starting to value companies based on their sustainability performance, creating new reputational risks. In *Action amid uncertainty*,[4] more than 40% of the respondents believe that equity analysts currently include climate change-related factors in company valuations. Climate change and sustainability performance is also linked to customer satisfaction and loyalty, strong supplier relationships and attracting and retaining top talent. Given the multitude of stakeholders exerting pressure on companies to manage risk and seize opportunities in this area, there has been a significant increase in external reporting. More than 1,200 companies worldwide now issue sustainability reports based on the Global Reporting Initiative (GRI).

Momentum is building for more integrated reporting of financial and non-financial information related to climate change and sustainability. Being prepared for this shifting environment will be very important. Managing stakeholder expectations is an area where risk can become an opportunity to increase brand and shareholder value.

4 Ibid.

What this means for Internal Audit

Internal Audit needs to assure management as to the integrity, consistency and timeliness of externally reported information. Executives and boards are acutely aware of the growing demand for more transparent reporting of climate change and sustainability business strategies, initiatives and performance. Companies are now using many voluntary reporting channels, including external sustainability reports, annual reports, external websites, the Carbon Disclosure Project and the Climate Registry. Internal Audit can assist in evaluating the accuracy and credibility of the sustainability reporting in advance of the increasing scrutiny this information is getting from external stakeholders.

In the Ernst & Young survey previously cited,[5] 64% of respondents currently communicate data on greenhouse gas or carbon emissions in an annual corporate social responsibility report or a sustainability report. Nearly a third state that their organization has not yet communicated this data publicly. The risk for those not communicating their climate change data is that stakeholders will seek this information from potentially less-reliable third-party sources.

For those companies that do report, there are challenges in ensuring that the report is an effective communication tool. The information needs to be relevant, complete and in line with the expectations of stakeholders. Done well, it provides a company with the opportunity to present a clear picture of the measures it is taking to meet the challenges and opportunities of climate change. Some leading organizations are beginning to integrate financial and non-financial data in a single report, which helps readers to get a better understanding of the full financial implications of the organization's business strategy.
In our survey, 62% of respondents who report have their data verified by an independent third party. The publication of an assurance statement with the sustainability report is an increasingly common approach to enhance a company's credibility and to meet growing stakeholder demand for transparency.

Questions Internal Audit should ask

- What is the current perception of the organization's stakeholders – investors, customers, employees – of the eco-friendliness of the company?
- Is reputational risk top of mind when climate change policy is instituted?
- Has management fully evaluated the ripple effects of negative customer satisfaction, shareholder activism or ineffective public disclosures and communications?
- Is the organization's reported data assured by an independent third party?
- Is Internal Audit working with the organization's external auditors to create transparent reporting of non-financial data?
- Does the company currently have adequate controls and processes in place in anticipation of the possibility that the SEC might require the inclusion of climate change information in registration statements?

5 Ibid.

5. Operational

One of the greatest challenges for companies in implementing their climate change and sustainability strategy revolves around implementation across operational business units and key functional areas. These include IT, supply chain and facilities. Climate change and sustainability-related issues are associated with physical risks linked to the physical impacts arising from climate change. This can result in damage to infrastructure and assets, reduced asset life and increased maintenance expenses, which can have the effect of increasing insurance premiums. Another significant operational risk is the rising cost of energy, which is one of the largest operating expenses for many companies. A company's response to climate change and carbon reduction — a risk area — is also an opportunity to reduce energy costs through implementation of efficiency measures.

Value chain risk associated with customers and suppliers is a growing operational risk area. Everyone is part of someone else's supply chain. Many companies are working directly with their suppliers with the expectation that the suppliers will provide the customer with sustainability performance information, including their carbon footprint, water and waste information and sustainable labor policies. Some companies are now required to complete a lifecycle greenhouse gas assessment of their products and to provide this information to their customers. Some companies are also being asked to disclose their plans for reductions in carbon content and costs. For all these reasons, companies are now focused on supply chain as both a risk area and as an opportunity to enhance operational efficiencies.

What this means for Internal Audit

Some of the biggest climate change-related risks and opportunities for companies exist within their supply chains. Many companies are already driving their climate change and sustainability strategies and greenhouse gas reduction goals through the supply chain. In our survey,[6] approximately 66% of respondents are discussing climate change programs with their suppliers, and 36% of respondents are already working directly with these stakeholders to decrease the carbon in their supply chains. Identifying supply chain risks and opportunities that arise from climate change can help:

- Mitigate risks to supply continuity
- Get products and services to market more efficiently
- Align brand value with changing customer demand

Internal Audit will also need to:

- Assure that the organization is complying with all the requirements of its environmental management system (e.g., ISO 14000)
- Evaluate whether there is adequate benefits realization from the organization's climate change and sustainability initiatives and ascertain that they are on time and on budget

Questions Internal Audit should ask

- What standards are being used for measurement? ISO 14000?
- Has your company estimated how a small long-term change in weather patterns or energy costs would affect the entire supply chain and margins?
- Are there adequate project management measurements in place?
- Has the organization completed a lifecycle greenhouse gas assessment of its products and/or services?

6 Ibid.

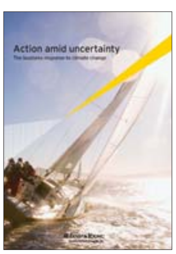
Ten actions Internal Audit should take

Internal Audit's main role is to provide objective assurance to the board and executive management that key risks are being managed effectively and in accordance with internal and external obligations. For climate change and sustainability-related issues, this mandate can be accomplished through the following 10 actions:

1. Embed climate change and sustainability as part of the Internal Audit risk assessment
2. Understand and assess key climate change and sustainability risks including: strategic, compliance, financial, reputational and operational
3. Validate that key climate change and sustainability risks are appropriately identified, prioritized and controlled within each business unit or process audited
4. Review processes for climate change and sustainability reporting, including evaluation of the integrity and alignment of data across all reporting channels
5. Share insights with management and the board so they have a clear understanding of the regulatory environment complexities
6. Coordinate climate change and sustainability risk assessment with other key risk functions
7. Review the corporate risk register and risk management policies for appropriate inclusion of climate change risks
8. Review and refresh the assessment of climate change and sustainability risk impact on a regular basis
9. Determine that management is monitoring and assessing the impact of existing or potential government regulations on the business
10. Report on climate change and sustainability risks regularly to the board

Our point of view

Download our current thought leadership and research findings at ey.com/climatechange



Action amid uncertainty: the business response to climate change

This global survey of 300 corporate executives from 16 countries with at least US$1b in annual revenue found that corporate executives expect to make significant investments to deliver both cost savings and revenue generation opportunities relating to climate change. Find out why — despite challenging economic conditions and regulatory uncertainty — they believe that the climate change agenda will significantly impact business performance and strategy over the next few years.

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