Sustainability

Emerging environmental, safety, and social risks provide internal audit an opportunity to deliver value outside of traditional EH&S compliance. Are you ready?

Highlights

As sustainability becomes more ingrained in your company's overall business model, internal audit should support the business in addressing emerging risks and exposures. Here's how:

- Assist management in developing strategic long-term approaches to operational issues
- Make compliance more efficient with practices that streamline operations
- Recommend improvements to internal controls for sustainability data, taking note of downstream information users

Many U.S. companies have established sustainability strategies to increase long-term shareholder and social value while mitigating the negative environmental and social impacts of their activities. These strategies have led to opportunities—including the development of increasingly popular green product lines—and to changes designed to make supply chains and operations more efficient.

Stakeholders have also begun to pay more attention to whether a company's practices are socially responsible. Social media and mobile communications spread the word rapidly among concerned groups, putting greater pressure on corporate brands. Meanwhile, federal and state regulations have been enacted that have begun to elevate sustainability in the U.S. from "the right thing to do" to a mandatory requirement.

With changes in many organizations' business models and risks, the importance of sustainability continues to increase in enterprise risk management programs. Our recently issued 2011 State of the Internal Audit Profession Study also indicated that corporate social responsibility and sustainability are growing areas of internal audit interest, with 35% of survey respondents indicating that their audit plans explicitly address these risks.

Some sustainability risks may lie in traditional environmental, health, and safety (EH&S), which, for many organizations, has historically been audited and monitored by internal audit. Others may be new or emerging issues that will require internal audit to develop innovative approaches and stretch the capabilities of the internal audit function.

In this paper, we discuss several emerging trends likely to impact businesses in 2011 and 2012 that deserve internal audit attention:

- Employee health and safety
- Corporate social responsibility reporting
- Conflict minerals
- Environmental Protection Agency's Clean Air Act greenhouse gas permitting and mandatory reporting regulations
- California cap-and-trade

What are the priority sustainability challenges for your organization? What are the exposures that may be created if your current response is uncoordinated? Are you ready?

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Employee health and safety

Keeping employees safe is still a pressing issue for many companies, despite the myriad of laws in place to assure worker safety. Consider this:

- In 2009, 4,340 workers died on the job in the United States.
- The BP Deepwater Horizon offshore oil spill was the worst spill in United States history. The incident cost 11 lives and followed a 2005 event for which BP was ultimately assessed $50.6 million in fines by the Occupational Safety and Health Administration (OSHA).
- OSHA conducted nearly 41,000 inspections in 2010 and reported more than 96,000 total violations, many of them serious. Enforcement actions in the hundreds could see penalties of over $100,000 each.

Companies least likely to suffer injuries, fatalities, and fines are those with rigorous worker safety management programs and systems. These companies also appear to be the best prepared for an increasing number of OSHA regulatory requirements.

Are you ready?

Program assessments and benchmarking can help companies understand whether their safe-work-practice programs meet regulatory requirements and if those programs are among the best in the industry. Analysis may include compliance only or compliance and governance. Industry leaders employ such corporate performance reporting to keep track of systems, processes, and controls surrounding compliance and governance.

Internal audit: Beyond OSHA compliance

Internal audit can do much to evaluate safety management systems, prepare for changing OSHA regulations, and design safe-work-practice standards.

But it's critical that internal audit get involved now, so it can help companies comply with new or changing health and safety requirements. Companies can implement a more efficient regulatory response by having internal audit:

- Conduct assessments or benchmarking studies to identify ways the company can improve systems, processes, and controls.
- Develop processes for collecting control data to report health and safety performance and key indicators.
- Establish more rigorous systems for vetting and analyzing baseline disclosure or performance indicators.
- Provide industry benchmarking and best practices for health and safety data collection and reporting, based on a range of indicators and focus areas.
- Help ensure the company has processes in place to reduce injuries, control workers compensation claims, and control the costs of general liability insurance.

Corporate social responsibility reporting

Investors, customers and stakeholders increasingly demand that companies report on their sustainability efforts. Voluntary sustainability reporting organizations, such as the Dow Jones Sustainability Index, the Carbon Disclosure Project, and The Climate Registry have become sources relied upon by the investor community. In addition, companies routinely communicate their social responsibility efforts via press releases, corporate websites, and other corporate communication vehicles, including social media.

Yet internal audit is rarely involved in verifying the accuracy and completeness of this information. Even the most sophisticated corporations may have inconsistent processes for gathering such data, essentially relying upon a few individuals and numerous spreadsheets. Because companies often issue corporate social responsibility reports in conjunction with other annual filings, the reports closely resemble financial reports that have been subjected to more rigorous control environments and regulatory requirements. As a result, readers may incorrectly assume that the information, including greenhouse gas, water and waste data, is "investment grade," i.e., based on mature, independently verified, rigorous reporting processes similar to financial reporting.

Are you ready?

Companies would be well served by ascertaining whether the corporate social responsibility reports and sustainability information they release are indeed investment grade. We believe this information should be prepared with the same degree of rigor used to collect and report financial data.

Internal audit: investment grade information

It is our view that robust and accurate corporate social responsibility reporting is yet another indicator to the investing public of corporate leadership. We believe that internal audit can play a critical role in the corporate social responsibility reporting processes including:

- Developing recommendations to management regarding the improvement of existing controls for assuring the accuracy and completeness of sustainability data.
- Providing recommendations to management regarding the types of disclosures made and whether the information is material, consistent with peers, and responsive to stakeholder needs.
- Evaluating the information to ensure it is consistent with data provided to the U.S. Environmental Protection Agency (EPA), California agencies, and other regulatory bodies.

Amid growing concern over climate change, federal and state governments have enacted or contemplated stricter regulations on greenhouse gas (GhG) emissions. In 2011 and 2012, new programs and rulings that may impact many companies will come into effect.

Conflict minerals

To reduce the funding of rebel groups associated with conflicts and extreme violence, the new Dodd-Frank Act includes annual disclosure requirements for SEC-registrants whose products or processes use gold, tin, tungsten, and tantalum from Democratic Republic of the Congo (DRC) or adjacent countries. The goal is to promote responsible sourcing through transparent public disclosures. The SEC estimates that the new conflict minerals legislation will impact approximately 6,000 issuers; however, the impact could be even greater considering a public company's use of private company suppliers.

Section 1502 of Dodd-Frank Act requires public companies to:

- Determine whether products and the supply chain contain conflict minerals.
- Conduct supply chain due diligence, determining the origins of minerals used in products, and establish a chain of custody over these minerals.
- Provide an audit report to the SEC if minerals are determined to be from DRC or adjacent countries or if the company cannot trace mineral origins.
- Use the information gained in the supply chain due diligence and audit in the required SEC disclosure.

Are you ready?

Companies may find it difficult to trace conflict minerals throughout the supply chain. This can be a time-consuming and difficult exercise, as the minerals are combined during smelting, refining, and manufacturing processes. Although the final rules are not expected from the SEC until the fourth quarter of 2011, we have been encouraging companies to begin the due diligence process to prepare for the final rules.

Internal audit: Sustainable supply chains

Internal audit is positioned to help companies implement the new supply chain regulations by:

- Helping management develop control processes for conflict minerals due diligence.
- Providing recommendations to management to develop a more rigorous system for tracking the conflict minerals chain of custody.
- Increasing transparency and accountability by auditing management's due diligence process, helping build trust and enhance credibility with stakeholders.
- Conduct pre-auditing of management's SEC disclosure for companies that use or cannot determine the origin of conflict minerals, thereby reducing cost.

EPA Clean Air Act GhG permitting and mandatory reporting regulations

The EPA began regulating GhG emissions under the Clean Air Act (CAA) permitting programs for many organizations on January 2, 2011. The expansion of the CAA enables the EPA to regulate GhG similar to other air pollutants, including lead, sulfur dioxide, and nitrogen dioxide.

These CAA rules phase in the applicability of the new GhG permitting requirements, beginning with larger emitters. By July 1, 2011, other sources will be subject to the ruling. Estimates of impact vary, but according to both the EPA and industry comments on the ruling, the new regulations could affect millions of organizations. Congress has agreed to continue to study the impact of the CAA regulations on the U.S. economy; however, President Obama has indicated he would veto new bills that propose to amend the CAA and prohibit the EPA from regulating GhG emissions to address climate change.

Beginning in 2011, facilities in certain source categories that emit more than 25,000 metric tons of GhG are required to annually report their GhG emissions to the EPA under the 2009 Mandatory Reporting of Greenhouse Gases rule. The EPA has recently extended the deadline for reporting 2010 GhG data to September 30, 2011.

Are you ready?

For many companies, meeting these regulations, assuming they remain in place, will require a significant increase in compliance and reporting efforts. Internal audit can help by considering the following questions, keeping in mind that a "no" answer may identify a place to start thinking about change:

- Is your organization prepared for compliance with new permit requirements for GhG emissions?
- Do you have effective and efficient processes in place to prepare and periodically report your GhG emissions inventory?
- Are you confident your GhG emissions inventory data is accurate and complete?
- Is the GhG data reported consistent with other public uses, including life cycle assessments and other responses to supplier GhG inquiries?
- Do you have internal controls to identify and help reduce inaccuracies that could damage the company's reputation?

Internal audit: A key to compliance

Internal audit can also play a significant part in helping comply with new EPA regulations. Internal audit can help by:

- Auditing compliance with changing EPA permitting and disclosure regulations.
- Ensuring the operational effectiveness of compliance-related EH&S processes and controls, e.g., routine compliance monitoring.
- Assessing internal control processes for collecting GhG emissions inventory data.
- Delivering best practices and knowledge about GhG permit compliance and emissions inventory data collection throughout your organization.

California cap-and-trade

If your company operates facilities in California and exceeds certain emissions thresholds, you'll need to start preparing for California cap-and-trade rules. While currently undergoing judicial suspension and appeal, the program is scheduled to take effect in January 2012, expanding to include other carbon sources in 2015. If implemented as planned, the program would make carbon a tradable commodity in California—impacting key sectors of the California economy by 2015. Other companies operating outside California would also be impacted by way of the supply chain.

Are you ready?

For the most part, U.S. based companies have not responded to the emerging need for robust GhG emissions tracking systems and carbon-trading policies and procedures. As a result, these companies may be unprepared for the new cap-and-trade regulation.

Internal audit: Credible carbon credits

Internal audit can help your company prepare for monetized carbon in California by:

- Assisting with the development of a strategic, longer-term approach to operational issues such as the purchase or sale of carbon allowances.
- Providing management and the audit committee with confidence in compliance by validating the accuracy and completeness of required GhG emissions inventory information.
- Lowering the cost of assurance or verification of the GhG emissions inventory required by regulation.

Bridging the gaps

When PwC introduced the concept of internal audit 2.0 a year ago, companies were poised to start thinking about changes to internal audit. Now, the pace of change has accelerated, with companies looking to seize new growth opportunities in sustainability.

In the face of industry and regulatory transformation, internal audit should help companies prepare by providing the same expertise offered to other financial and operational aspects of the business. This includes helping improve processes, controls, and compliance related to sustainability. It's time to ask: Are you ready?

Despite economic and regulatory uncertainty, companies are moving forward, navigating new courses for sustainable growth and operations.

What can you do to get onboard?

Look closely at your organization's risk assessment. Does it include an evaluation of environmental and social trends that could pose a risk to the business? Is it ready to keep pace with some of the changes described above?

Leading internal audit functions have already begun looking beyond their departments to partner with others both in and outside their companies.

At PwC, we offer in-depth, practical solutions for expanding internal audit sustainability capabilities. For help bridging the gaps in your organization, we welcome you to contact us.

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Other publications

Corporate social responsibility reporting
http://www.pwc.com/us/en/corporate-sustainability-climate-change/publications/creating-value-from-corporate-responsibility.jhtml

Conflict minerals
http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-conflict-minerals-disclosures.pdf