The Changing Climate of **Audit** and **Risk Committees**

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Environmental, social and governance (ESG) risks have risen up the boardroom agenda thanks to ever increasing expectations from institutional investors, regulators and standard-setters around the world calling for more transparent disclosures on how companies are addressing these issues and the materiality of them.

In India, the momentum is picking up pace with recent regulatory developments. In May, the Securities and Exchange Board of India's (SEBI) introduced mandatory ESG reporting requirements for the top 1,000 listed companies (by market capitalisation). Known as the Business Responsibility and Sustainability Report (BRSR), these new disclosure rules go into effect from the financial year 2022 to 2023 and make a significant step from SEBI's existing Business Responsibility Report in terms of bringing ESG to the fore of financial reporting in India.

The BRSR format is based on the nine principles of India's 'National Voluntary Guidelines (NVGs)', which are intended to define responsible business conduct for Indian companies, and moreover are based on internationally-accepted ESG standards, including the UN Guiding Principles on Business and Human Rights, the UN's 17 Sustainable Development Goals, the Paris Climate Agreement and the International Labour Organization (ILO) Core Conventions.

Climate risk has become a pressing focus for both business leaders and public policymakers in the lead-up to COP26, which takes place later this year in November from Glasgow, UK. Prudential regulators, such as SEBI, are stepping up efforts to encourage companies to align their disclosures with the Paris Climate Agreement's goal of reducing carbon emissions by 50% over the next decade, and getting countries to collaborate on this is the main goal of the event. The collective responsibility globally to meet the target of a net zero economy by 2050 is centered around companies, public and private, and their integral role in limiting climate catastrophe – not just through supply lines but also by impacting value chains and ultimately the way the world consumes. Growing pressure from investors and other shareholders and stakeholders presents boards all over the world with mounting challenges given the urgency and complex materiality of the socio-economic risks of the rapid climate change we face today.

While it is the boards' fiduciary duty to drive the company's climate change actions, we see most delegating climate risk reporting to sub-committees, and we find that regulatory and investor expectations globally are focused more on that being the responsibility of the audit committee or the audit and risk committee. This still varies across businesses and sectors. If you consider comparing Energy and Financial Services, for example, each has a different stage of evolution given the varied organisational models and existential threats to their operations. It also depends on whether the company is in the business of selling carbon, selling to customers who use carbon, or financing economic development, which can either exacerbate or help climate change challenges.

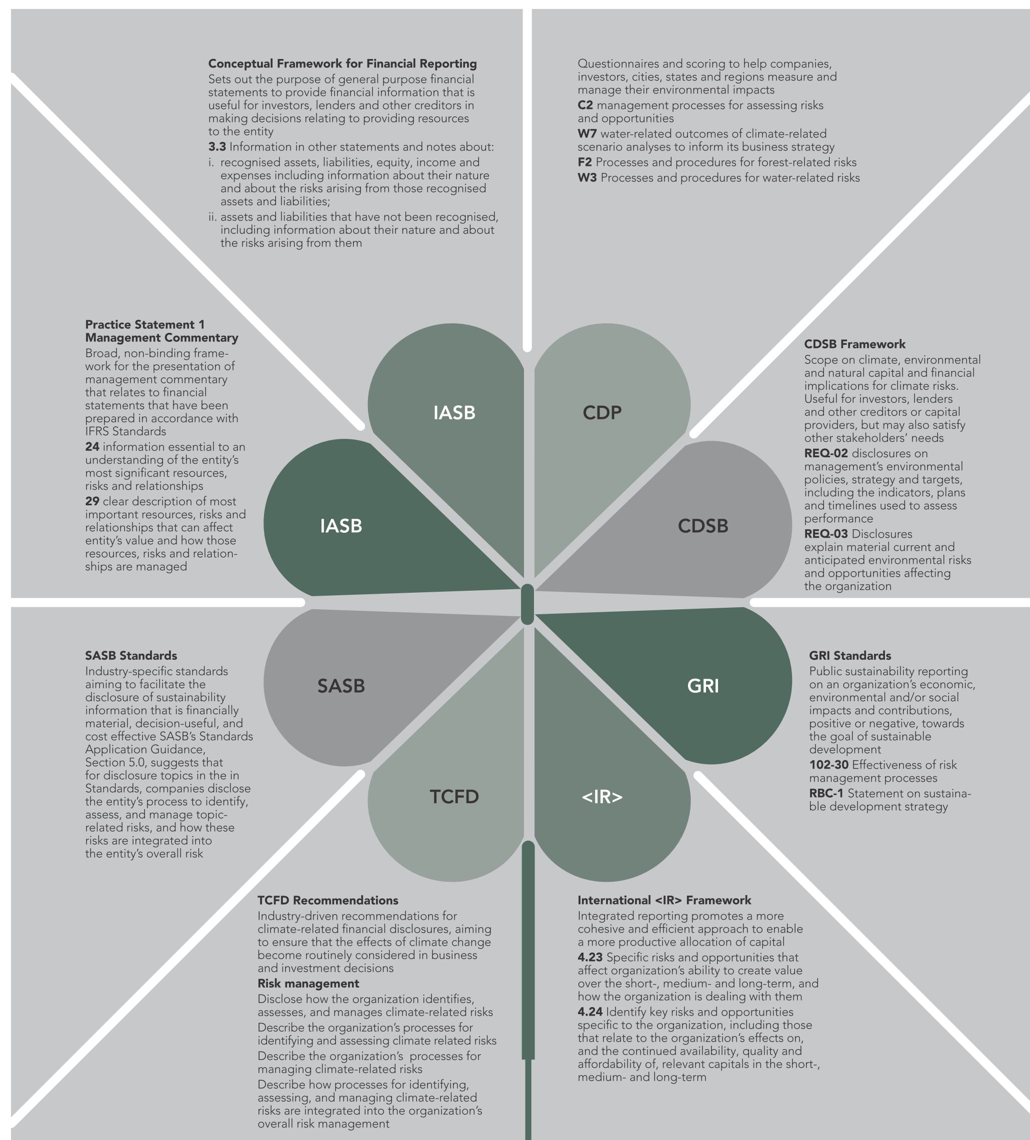
This topic was unsurprisingly a recurring theme during the panel discussion held by the Institute of Directors India's virtual event in February 2021, '*The Roles and Challenges of the Audit Committee in Corporate Governance*'.

At the event, *Mr. Partha Bhattacharya, Former Chairman at Coal India and Former MD at Haldia Petrochemicals*, talked about how the audit committee in particular can enhance corporate governance enforcement in this new norm. 'It's a very dynamic kind of process of change that we see happening with audit committees. What we knew about the audit committee five years back is very different from what it is today. For example, there will need to be assurance covering all the different aspects of climate change, and considering thousands of corporations that have already pledged to becoming net zero by 2050 and the over 120 countries who are joining them, climate risk was bound to become a large priority that audit committees must address. As an audit committee chair it becomes our duty to lead this journey.'

The Task Force for Climate-related Financial Disclosures (TCFD) has been an important impetus in getting board-level committees more committed to addressing these existential risks. Likewise, the Reserve Bank of India (RBI) is increasing its expectations of banks to improve their accounting for climate risks by recently joining the Network for Greening the Financial System, a voluntary group of 62 central banks aiming to help members design policies that incorporate environment and climate risk in the financial sector. Other accounting standard-setters, for example, the newly formed Value Reporting Foundation, a merger between SASB and IIRC, and co-Chaired by Professor Mervyn King and Michael Bloomberg, are also pushing the climate agenda into audit committee metrics. See Figure 1 'Climate Risk Reporting'

Figure 1: 'Climate Risk Reporting'

(From the report- 'Rethinking Risk for the Future: An India Perspective)



'Framework providers are striv -ing to get the same public good outcome of making reporting more informed so that we can make accountability more transparent. We must start realising that SDG 17 is perhaps the most important SDG because without collaboration, we are not going to achieve anything,' Professor King, who is also an honorary member of ACCA's Global Forum for Governance, Risk and Performa -nce, spoke to ACCA members in April for the *Rethinking Risk for the Future* video.

While some sectors will be impacted by climate change more than others, SEBI pointed out in its BRSR announcement that all businesses in some form or another will be affected. Given the energy transition that the world is trying to implement, it is difficult to see how any sector or company will be untouched by that. The climate urgency is rewiring the DNA of the global economy, and enhanced disclosures by certain compan -ies in the oil and gas sector have demonstrated just how material climate risks are. This is discussed in further detail in a recent ACCA report,

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***Climate Change Risk – Related Disclosures in Attractive Industries*.**

In Financial Services, the focuses are on risks to the portfolio and lending, including opportunities in real estate and transport, particularly automobiles, while the Energy sector is naturally more focused on its core business and transitioning that into one which is not dependent on carbon production. Conversations might have different angles and be at different levels of maturity, but we have seen them become the remit of audit committees in both sectors globally.

As Mr. Bhattacharya pointed out, audit committees are also becoming more involved with strategy as the risk landscape changes so rapidly. Audit committees are playing a bigger role in what goes into annual reports and other statements, particularly with non-financial numbers given the fast adoption of digital technologies and growing amount of intangible assets. With new rules around operational resilience on the horizon, the audit committee also needs to assess internal control framework and drive new ways of thinking about risk from the top down. Its assurance responsibilities will be increasingly crucial going forward in terms of how the company understands the risks that they face; how they measure them; how they measure progress; and, indeed, how this becomes consistent across sectors. Audit committees will be at the centre of this transformation in risk management, as regulations change and digital transformation continues to accelerate.

Addressing the biggest risk of all – failing to address sustainability

Through our engagement with members for the *Rethinking Risk for the Future* report, we found that while the increasing collective action driven by institutional investors and prudential regulators across the globe is producing a keener awareness of environmental and social matters, organisations are not taking as much action on net zero pledges as shareholders and stakeholders now expect. This is often because the necessary mindset from the top, the board and senior management, is not evident. See Figure 2, 'The biggest risk of all'.

There are many ways boards and senior management can foster a sustainable culture and it starts by keeping long-term values and all stakeholders' needs in mind. Stakeholder mapping is an effective exercise, in this respect, that involves identifying, analysing and prioritizing the groups that have a stake in your company's activities. Stakeholder mapping can help boards and senior management understand stakeholder expectations better and ensure that it is considering the most impactful issues as it shapes its strategy.

Figure 2: 'The biggest risk of all'

(From the report- 'Rethinking Risk for the Future: An India Perspective)

Once stakeholders' needs are considered, companies can identify both the risks that can damage the business as well as the external, systemic risks that the company's activities can exacerb - ate for society at large, for example, with their greenhouse gas (GHG) emissions or potential gender pay gaps. The role of audit and risk committees in ensuring that applicable matrices to measure climate risks are created is crucial for understanding the impacts and opportunities pertinent to their companies and providing the transparent information that shareholders and other stakeholders are demanding. Audit and risk committees need to understand these risks, as materiality itself also evolves, and drive the development of relevant key performance indicators (KPIs) needed to work out how the company is doing and key risk indicators (KRIs) to reveal what might hinder its performance in the future.

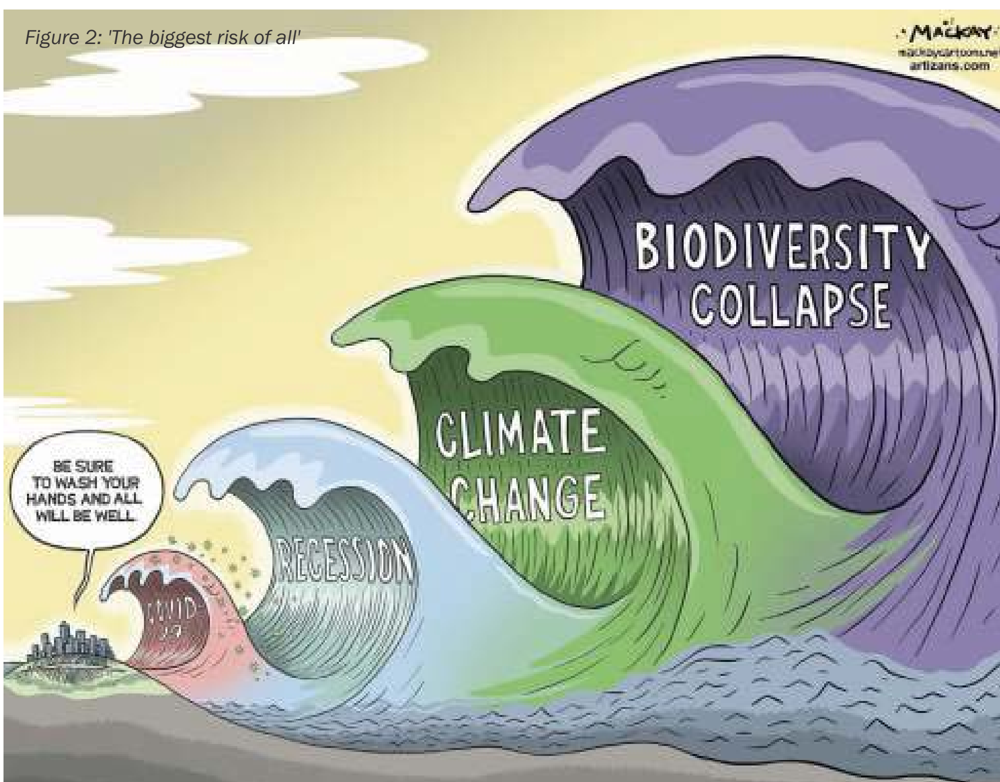

Figure 2: 'The biggest risk of all'

By evaluating the risks and rewards of the ESG concerns most relevant to the company and assessing the resources required to manage them, boards and board committees can optimise the organisation's decision making and set objectives that help steer the company in the right direction. Managing risk and sustainability in this new increasingly uncertain world requires a set of values that must be both top-down and bottom-up if ESG issues are to be addressed successfully. Audit and risk committees could be cultivating this cultural shift by asking more questions to senior management and other board committees in making sure that the appropriate systems are in place and that the organisation and its stakeholders are adhering to the same values.

The art and science of climate reporting

ACCA members in India and around the world say they believe that reporting changes behaviour, with many arguing that it is a mechanism for accountability. Nevertheless, many admit that sustainable reporting can often be viewed more as a marketing exercise. As one ACCA member, who is head of internal audit of global brand in the travel and leisure industry, said: 'It can be difficult to find the evidence to back our sustainability statement.'

'Companies are at risk if they say they have policies to be net zero by 2050 but at the same time do not identify climate change as a significant risk. There's something they're not understanding, or they might be introducing net zero-related policies for the wrong reasons,' added another ACCA member who is a risk advisory consultant.

One of the pain points in the sustainability reporting journey is deciding what to focus on and which issues to address. Materiality helps to answer this question. Of course, it is important to concentrate on the issues that matter to your business, but also on the impacts your company may have on the communities, agriculture, ecological, financial and industrial systems it depends on. This is discussed further in another recent ACCA report, **Invisible threads: communicating integrated thinking (Chen and Hawksley, 2021)**.

A wide range of factors, such as the nature of production processes and value chains, the location of the business sites and relationships, and interdependencies with customers and suppliers, all play a part in how companies are affected by climate risks.

What's clear is the importance of understanding the interconnectedness of ESG risks. As the pandemic has proved, all these risks have a financial impact and that's why reporting on them is becoming more mainstream and the role of audit and risk committees more integrated.

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This article is based on the recently released report – 'Rethinking Risk for the Future: An India Perspective', developed by IOD, India along with its strategic partner, ACCA (Association of Chartered Certified Accountants).

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