GLOBAL KNOWLEDGE BRIEF

Sustainability

Part 1: Preparing for the Next Wave of Sustainability Regulations

Workiva

The Institute of Internal Auditors

Contents

About the Expert

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Mandi McReynolds is an award-winning author with nearly two decades of experience leading ESG teams across four industries. As the vice president of global ESG and chief sustainability officer at Workiva, Mandi helps executives around the world drive business value and societal impact through transparency, accountability, and innovation. Mandi also co-hosts ESG Talk, a weekly podcast featuring candid conversations with business leaders exploring the intersection of sustainability, finance, and GRC.

INTRODUCTION

When it comes to sustainability reporting regulations, change has arrived. New mandates from bodies that include the European Union and the U.S. Securities and Exchange Commission mean that sustainability reporting controls and compliance are now critical concerns for organizations.

This new regulatory regime promises to influence how organizations approach sustainability reporting and could well influence sustainability-related goals. In the meantime, the added level of public information available on sustainability efforts is expected to continue to drive asset management investment decisions.

This brief addresses how internal auditors can support their organizations in managing the new wave of regulation.

Understanding New Regulations

Disclosure rules expanding globally

From Voluntary to Mandatory

Until recently, corporate sustainability reporting was typically voluntary, allowing organizations to choose which standards or elements of standards they wanted to follow and how or where they wanted to report on them. Yet with more than 500 formal and informal standards and frameworks available, organizations grappled to determine which guideline or combination of guidelines best suited their needs, while those who rely on financial statements struggled with a lack of comprehensiveness or comparability in reporting.

That will now change, at least to some extent, with the European Union and the United States adopting robust new disclosure regulations and the International Sustainability Standards Board providing baseline guidance that is expected to be adopted in numerous jurisdictions. The list of countries requiring some level of reporting on climate and sustainability efforts is expanding rapidly, including major economies such as Brazil, Canada, Japan, New Zealand, Singapore, and the United Kingdom. New guidelines that are expected to drive change include:

- The European Union's Corporate Sustainability Reporting Directive (CSRD) became effective for FY2024 reports published in 2025. It is made up of five environmental standards, four social standards and one that applies to governance, and it generally applies to larger companies, based on revenues, assets, or employees. The rules apply to some non-EU companies, and listed small and medium-sized companies can use simplified versions of the regulations.
- The U.S. Securities and Exchange Commission (SEC) recently finalized significant new reporting requirements for publicly traded companies on climate-related information that must be included in registration statements and annual reports, including:
    - Material climate-related risks, and activities to mitigate or adapt to such risks.
    - Information about the registrant's board of directors' oversight of climate-related risks and management's role in managing material climate-related risks.
    - Information on any climate-related targets or goals that are material to the registrant's business, results of operations, or financial condition.

What's more, the SEC rules require disclosures by some filers of Scope 1 and Scope 2 greenhouse gas (GHG) emissions. Scope 1 emissions are those directly controlled by the company. Scope 2 emissions are indirect emissions typically related to energy the organization has bought from another source. Companies are also required to issue attestation reports on the required disclosures. Compliance is phased in based on the SEC registrant's filing status and the content of the disclosure.

It should be noted that not all businesses are embracing the new regulations. Legal challenges to the new SEC regulations were filed in at least six U.S. Circuit Courts, with at least one succeeding in staying the new rules. In light of the various legal challenges, the SEC voluntarily issued its own stay pending judicial review.

New regulations are not limited to national jurisdictions and new sustainability reporting guidelines also are expected to influence how organizations approach sustainability reporting and the quality of information stakeholders will see.

- A pair of new California laws —the Climate Corporate Data Accountability Act and the Climate-Related Financial Risk Act— are expected to have a broad impact because they apply to any large company that does business in the state, including private entities. In 2026, companies will have to begin reporting on Scope 1 and 2 emissions in the prior fiscal year. Starting in 2027, they will have to report Scope 3 emissions, which are those associated with their supply and value chains, for the previous year.

- Although they are not mandates, new guidelines from the International Sustainability Standards Board (ISSB) are expected to influence sustainability reporting worldwide, with nearly 400 organizations from 64 jurisdictions promoting their adoption. The ISSB's initial standards include IFRS S1, *General Requirements for Disclosure of Sustainability-related Financial Information*, and IFRS S2, *Climate-related Disclosures*. The ISSB was created by the IFRS Foundation to develop a comprehensive baseline of sustainability disclosures that meet the needs of investors and financial markets.

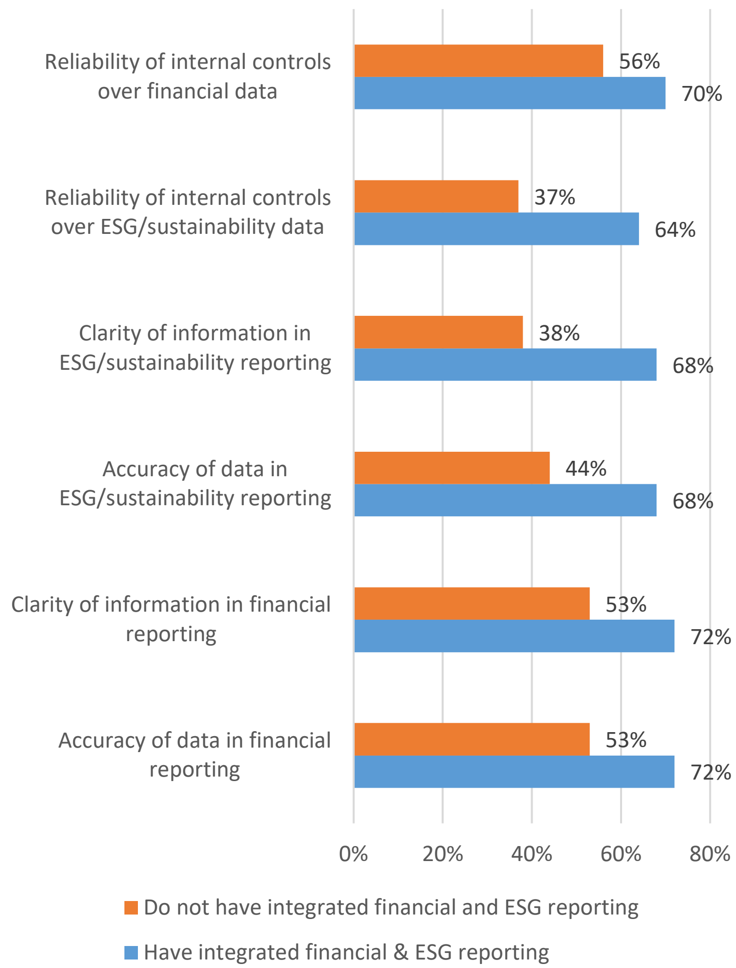
Getting the Right Start

Planning for success

Three Keys

These new guidelines have clarified the field to some extent, but they have also added more complexity. According to Workiva's 2024 Executive Benchmark on Integrated Reporting, 74% of executives believed that complying with regulatory requirements will become significantly more challenging in the next year[1]. For example, one Workiva customer was preparing to address 35 different ESG regulations in the coming year, based on its jurisdiction and the locations where it does business, according to Mandi McReynolds, vice president of global ESG and chief sustainability officer. Even if companies have no mandates and are able to use a common principle like the ISSB standards, they may choose to follow a stricter standard if it can enable compliance in a wide range of regions as new rules continue to roll out. New standards may also raise stakeholder expectations, so that organizations may be expected to comply with guidelines that aren't technically mandated for them.

Figure 1:



2024 Executive Benchmark on Integrated Reporting, Workiva, 2024

McReynolds recommends that organizations can enhance their abilities to comply with new expectations if they follow these steps as they gear up for compliance:

- **Prepare for complexity.** Understanding standards may not be the only complication that organizations face. When asked about the most significant hurdle to integrating financial and ESG/sustainability reporting, 52% of executives in the Workiva study pointed to the complexity of data collection. When it comes to having the resources to tackle new complexity, beyond the existing talent crunch for finance

[1] *2024 Executive Benchmark on Integrated Reporting*, Workiva, 2024.

and accounting professionals, organizations are also struggling to find people with sustainability expertise who can tackle increased data complexity and reporting needs.

- **Leverage existing approaches.** Instead of seeing sustainability reporting as a completely new task, organizations would do well to approach sustainability regulation the same way they already address financial reporting McReynolds advised. In both cases, there is global agreement on the need to report, but rules will be different in various countries, regions, and states. Organizations can examine the strengths and weaknesses of their financial reporting and apply what they learn in sustainability reporting.
- **Don't neglect the value.** While organizations may see sustainability disclosure as a significant new compliance burden, they should begin the process with an understanding of the potential value that a more holistic and integrated view of financial and sustainability performance can offer. Workiva found that companies that engaged in integrated reporting were more confident in the accuracy and clarity of data in their financial and sustainability reporting as well as the reliability of internal controls over financial and sustainability reporting, for example (see Figure 1), and that companies that integrate reporting are more attractive to investors.

A New Focus on Controls

Aligning on rigorous reporting

Mind the Gap

While there is growing alignment on the need to apply the same rigor to non-financial reporting that is seen with financial reporting, the chasm between executive and manager views on how well we're doing is wide. According to the Workiva survey, 62% of executives strongly agree that their company applies the same diligence to ESG reporting as it does to financial reporting, but only 32% of managers say the same. They also aren't aligned on whether the company has tapped someone internally to oversee ESG-specific reporting and initiatives. 87% of executives say they have, but only 67% of managers do.

62

PERCENTAGE OF EXECUTIVES WHO STRONGLY AGREE THAT THEIR COMPANY APPLIES THE SAME DILIGENCE TO ESG REPORTING AS IT DOES TO FINANCIAL REPORTING.

32

PERCENTAGE OF MANAGERS WHO SAY THE SAME.

Workiva Global ESG Practitioner Survey

"An important responsibility of the internal audit function is to assess and monitor the performance of an organization's controls," according to COSO's guidance on internal control over sustainability reporting, which notes that this monitoring function applies to internal controls over sustainability reporting as well as over financial reporting[2]. The monitoring function, "extends to any risks that could affect the organization achieving sustainable business objectives," it said. The COSO study includes:

- References that explain and underscore the internal audit function's important role in sustainability reporting.
- Issues for organizations to consider as they build and maintain effective controls over financial and sustainable business information.
- References to internal audit's role in offering objective assurance on the effectiveness of sustainable business risk management, reporting, and related regulatory compliance, as well as other key efforts related to sustainability.

At Workiva, internal audit and finance have worked together to address necessary improvements in controls over nonfinancial data, McReynolds said. And while quantitative data is important, the teams also discussed how to manage qualitative data in sustainability reporting. Qualitative data might be important in assessing a range of new considerations, such as governance, the organization's impact on its community, and its success in DEI efforts. It might consist of interviews, focus groups, surveys, or even photos or drawings, based on the issues involved. Organizations will need to identify what information they have available to them and then how to gather and assess it. McReynolds recommends performing a gap assessment now to identify what's missing and what areas

[2] "Achieving Effective Internal Control Over Sustainability Reporting (ICSR): Building Trust and Confidence Through the *COSO Internal Control—Integrated Framework*," COSO, 2023.

need better information-gathering processes, and then determine how to measure the data. Internal audit can also team with risk management to identify material sustainability-related threats—and opportunities--and whether they are immediate or emerging.

Companies should also be able to determine what information they don't need. One important determination regarding the SEC rules is whether GHG emissions relate to something that is within the organization's direct control, in which case the emissions must be reported as a Scope 1 or 2 emission. If not, they are a Scope 3 emission that need not be reported. As an example, Workiva leases buildings, but it has no control over the properties or their energy use, so it determined their emissions were a Scope 3. In the gap analysis, "be clear on whether the company has operational and financial control," McReynolds said, "because you may not have to pursue that data." This process can also help organizations make smart decisions about metrics to ensure that they are aligned to areas that are truly material to the business. "You have to take a strong stand on what's material, otherwise you could be chasing too many metrics," McReynolds said.

Investors clearly continue to put stock in sustainability reporting: Workiva found that 82% of investors consider ESG in their investment decisions. "You must understand what is important to your investors and stakeholders," McReynolds said. Customers, as well, want more information on sustainability from organizations in their supply chain.

The Value of Internal Auditors

Experienced reporters leverage independent assurance

Avoiding Surprises

A Workiva Global ESG Practitioner Survey of ESG practitioners in organizations that have been reporting on sustainability the longest found that they were more likely to involve their internal audit or risk management teams in the process, indicating an appreciation of the value of internal audit's contributions[3]. Because internal auditors often provide early warnings on risk and potential threats, their input will be crucial as organizations navigate an unfamiliar reporting and risk environment, McReynolds said. When it comes to compliance, "it's important for it to be a team sport," she said. As the demand for financial and sustainability reporting increases and companies move into a low carbon economy, "they will want their internal audit and risk professionals right there at the table with them," she said. "Internal audit will be an incredible partner on the team."

Among other things, internal audit can provide an initial look at updated control, risk, and reporting processes so that companies have a chance to improve them before they are made public. "Internal audit and external professional service firms, acting as consultants, have significant expertise in considering risks and assessing system effectiveness, sometimes called 'readiness assessments,'" according to COSO. "These assessments can bring forward the steps that an organization may take to improve its systems in a way that parallels the techniques used for mainstream financial reporting."

Organizations should consider having an internal audit before an external one, McReynolds recommends. If the organization has an external audit without gaining insights from internal audit, it may be faced with unpleasant surprises that could have been fixed sooner. If internal audit performs an audit of controls and reporting first and reports the results to the audit committee of the board instead, further action can be taken and the company can be better prepared for its external audit. "It's great to have an internal auditor with you as you navigate the new world of ESG audits," she said.

Internal auditors and their organizations can also benefit from leveraging technology for their compliance needs. Executives are likely to be on board, considering that 83% thought generative AI would help organizations comply with regulation, and more than half of institutional investors use generative AI to evaluate financial and ESG performance, Workiva found. At the same time, virtually all ESG practitioners surveyed saw technology as crucial in successfully managing ESG reporting and thought access to technology and data would be key to decision making to advance ESG strategy going forward. "Companies will have to have conversations around technology innovation investments they should be making to comply with regulations and streamline the work and complexity they are facing," she said.

[3] *2023 Global ESG Practitioner Survey,* Workiva, 2023.

Conclusion

Looking ahead, internal audit should ensure that sustainability reporting considerations are incorporated into their audit plans. "Start now if you haven't already done so," McReynolds said. In its advisory role, internal audit can provide advice on designating sufficient resources to address new reporting goals or mandates and on building up internal controls and data collection to the same level of trust as internal controls over financial reporting. Internal auditors can also provide perspective on how the board receives sustainability information. Organizations may want to review and update various committees' charters to include their sustainability responsibilities and determine whether sustainability efforts would be reported to the full board or to a separate sustainability committee, the audit committee, the nominations and governance committee, or another committee. "Internal audit can be a huge partner in managing these considerations," McReynolds said.

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