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<u>New COSO Guidance Addresses Environmental, Social and Governance-related Risks</u>

Draft supplements Enterprise Risk Management Framework

The November 2017 issue of the Audit & Accounting Alert showcased the then newly released *Enterprise Risk Management—Integrating with Strategy and Performance* (ERMISP). Developed by the American private sector group, Committee on Sponsoring Organizations of the Treadway Commission (COSO), the ERFISP was the latest update of the internal control and risk management framework COSO has been promoting for the past 25 years to help organizations reduce fraud and operate more efficiently.

Recognizing the growing challenges presented by environmental, social and governmental risks, COSO has now produced supplemental guidance to the framework that was issued for review and discussion on February 7, 2018. Titled *Enterprise Risk Management – Applying enterprise risk management to environmental, social and governance-related risks* (ESG Guide), the 151-page draft was developed in collaboration with the World Business Council for Sustainable Development (WBCSD) as an "engaging, innovative process focused on organizational integration to create shared value. All organizations set strategy and periodically adjust it, staying aware and ahead of both ever-changing opportunities for creating value and the challenges that occur in pursuit of that value."

The ESG Guide opens with a comparison of the risk landscape from ten years ago to today, as described by the World Economic Forum's *Global Risk Report*. The top five global risks in terms of likelihood are:

2008	2013	2018
Asset price collapse	Severe income disparity	Extreme weather events
Middle east instability	Chronic fiscal imbalances	Natural disasters
Failed and failing states	Rising greenhouse gas emissions	Cyberattacks
Oil and gas price spike	Water supply crisis	Data fraud or theft
Chronic disease, developed world	Mismanagement of population ageing	Failure of climate change mitigation and adaptation

The top five global risks in terms of impact are:

2008	2013	2018
Asset price collapse	Major systemic financial failure	Weapons of mass destruction
Retrenchment from globalization (developed)	Water supply crisis	Extreme weather events
Slowing Chinese economy (<6%)	Chronic fiscal imbalances	Natural disasters
Oil and gas price spike	Diffusion of weapons of mass destruction	Failure of climate change mitigation and adaptation
Pandemics	Failure of climate change mitigation and adaptation	Water crisis

While most of the issues are still prevalent, the top ones appear to have moved from economic and societal to environmental and the emergence of technological ones. In any event, they point to potentially monumental situations that have not been well quantified or disclosed in financial reporting. The ESG Guide also refers to a survey of institutional investors that "revealed that more than 80% of institutional investors surveyed agreed that for too long, companies have failed to consider environmental and social risks and opportunities as core to their business. They believe that ESG issues have 'real and quantifiable impacts' over the long term and that generating sustainable returns over time requires a sharper focus on ESG factors."

To assist entities with incorporating ESG concerns into the ERMISP, the ESG Guide lays out seven modules:

1. Establish governance for effective risk management
2. Understand the business context and strategy
3. Identify ESG-related risks
4. Assess and prioritize ESG-related risks
5. Respond to ESG-related risks
6. Review and revise ESG-related risks
7. Communicate and report ESG-related risks

Integrating ESG-related risks into the ERMISP, according to the ESG Guide, will lead to:

1. Enhanced company resilience
2. A common language for articulating risks
3. Improved resource deployment
4. Enhanced pursuit of opportunity
5. Realized efficiencies of scale in considering ESG-related risks entity-wide
6. Improved disclosure

The ESG Guide has an in-depth chapter on each of the seven modules, presenting examples and resources along with regulatory and voluntary initiatives that can be drawn upon for assistance. Not surprisingly, leadership, tone at the top, attitude and establishment of organizational accountability must come first, followed by a thorough grasp of operational factors and positioning in the world. Once these are firmly in place, the organization can proceed to discern approaching near and longer-term risks, allowing time to prioritize and develop effective response strategies. The process is ongoing to assure awareness as new and changing circumstances present themselves. Finally, disclosing the risks and response strategies to stakeholders completes the cycle. Criteria and standardized methods for quantifying the wide variety and forms of risks are continually improving. Technological advances and agencies focused on ESG measurement and disclosure are leading the way.

Further details can be found at Draft Guidance on Environmental, Social and Governance-related Risks

(https://www.coso.org/esg/Pages/viewexposuredraft.aspx)