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Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

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ESG's Role in Managing COVID-19 Impacts and Risks

The COVID-19 pandemic originated as a public health crisis and quickly expanded to encompass economic and social governance aspects. With work-from-home mandates starting to ease, the pandemic is morphing once again. This time, it will test our abilities to manage workplace safety, where occupational safety and health considerations certainly will influence financial and operational performance.

The impacts of COVID-19 are undeniable, and many of the pandemic's effects and attendant risks are centered in Environmental, Social, and Governance (ESG) issues. It stands to reason that how they are managed must be centered on ESG principles, which are based on the notion that climate change, human rights, and similar issues can and do affect the performance of investment portfolios and should be considered alongside more traditional financial factors.

As a core component of ESG, health and safety is the focus in worldwide public health briefings and government and corporate decision-making. The importance of embedded ESG specialists in both government and corporate organizations is essential. A commitment to embrace ESG criteria will help determine the future financial performance of organizations and ensure greater resilience.



What is the path back to normal and what does it look like post pandemic? For those charged with governance, it may be helpful to consider the difference between impact and risk (see sidebar), and how a clear understanding of ESG can place it front and center in supporting business success and longevity. The investment community is predicting that organizations with embedded ESG principles will better manage investment risks and rebound much quicker from the pandemic crisis.

Looking Back

A global pandemic was not wholly unanticipated. In 2003, SARS provided a preview of COVID-19 that prompted many companies to review and adjust their business continuity plans (BCPs). Companies relied heavily on specialists to forecast possible impacts, identify risk reduction measures, and plan for future occurrences. We can use this previous work to better understand our current situation and strategize for what's to come.



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The Institute of Internal Auditors Inc. (IIA) is a global professional association with more than 200,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

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Now is the time to employ an ESG mindset to investigate the root causes of corporate vulnerabilities and understand where and why existing plans did not meet expectations. In performing the review, an ESG and risk management examination should include such questions as:

- Did risk registers include all the risks?
- Were the risk registers written and maintained by personnel with the appropriate expertise and skill sets?
- Did the organization use specialists effectively to identify and assess risks, and to evaluate risk mitigation measures?
- Were risks that originated outside the organization accurately considered?
- Did the organization effectively identify new or emerging risks, including information submitted through whistleblower hotlines?
- Were BCPs up to date, tested, revised, and maintained?

Organizations also should examine what caused impacts to be so substantial for this crisis and ask questions such as:

- Were provisions for paid sick leave sufficient? Did employees feel pressure to come to work, even if they were sick?
- Was the company overly reliant on one vendor for a critical product or service? Was a just-in-time supply chain stretched too thin?
- Were communications networks established and operating? Were employees able to use them?
- Did the organization's culture support speaking up?
- Were prescient audit recommendations and suggestions addressed?

QUESTIONS FOR BOARD MEMBERS

Don't accept a management report that only includes "cut, cut, cut." Challenge management's strategy, plans, and direction for the long term with questions such as:

- » What have you learned about how the organization was prepared for this? How deep did you dig and what resources did you use? What are the lessons learned, and how will you address them in the future?
- » What do you regard as critical interim and long-term risks? Besides the obvious financial risks, what non-financial risks (including ESG) have been considered? How are they being identified, assessed, and mitigated?
- » What are the new/emerging risks you're tracking — on both global and macro levels — and how could they affect our sector and organization?
- » What opportunities arise, either interim or longer term? What are the plans to make the most of them?
- » What are the plans for financial and non-financial reporting and disclosures? Are systems and controls effective for this dynamic situation? How are you monitoring stakeholder reactions?



Risk: Mitigate the Downsides

The “temporary normal” poses new risks to operations, compliance, and organizational reputation. Some short-term risks are highlighted by the questions below:

- Are employees working from home able to be productive and contribute? Are company technology and management equipment sufficient to support working from home?
- Are other organizational requirements or cultural norms fading and affecting engagement? Without a feeling of belonging, will employees look for other jobs?
- Is there a greater risk of theft of intellectual property?
- Has the organization taken on new compliance obligations, or have some obligations changed? These could include government relief packages, concessions from vendors or customers or contractors, or rent or tax relief.
- New regulations are inevitable post pandemic; how might workplace safety and workspace capacity changes affect the business?
- How have the expectations for external reporting (financial and non-financial) changed?
- How do the organization’s activities and responses to the global crisis or the sector’s activities and responses reflect on social media?
- What does health and safety look like? What responsibilities does an employer have for the safety of a home workplace? Under what circumstances will people be disciplined?

As the economy emerges into a new normal, still other risks may arise:

- Employees may be afraid to return to work, for health reasons or due to post-trauma stress.
- Systems and controls may not adapt to new compliance obligations.
- Competitors may have seized opportunities with products, services, markets, or employee benefits.
- Stakeholder expectations for disclosure of risk management practices (such as in Form 10-K Management Discussion and Analysis and Organization Sustainability/ESG Reports) may increase.

Risk: The Possible Upsides

Risk includes failing to grasp opportunities — look no further than the diverging fortunes of Blockbuster and Netflix. Despite the challenges, there will be upsides, but they may not be obvious or immediate. They could arise from fundamental shifts in market forces, or competitors being too reactive and short-sighted.

UNDERSTANDING IMPACT VS. RISK

Organizations often falter in crisis when they do not understand the difference between impact and risk. What organizations are experiencing as a result of the pandemic is “impact.”

- » Strained health care systems with severe resource deficiencies.
- » COVID-19 infections and deaths.
- » Government “Safe at Home” initiatives.
- » Drastic financial impact to business sectors: manufacturing, retail, transportation.
- » Dramatic increase in unemployment and loss of health care.
- » Complete disruption to education at all levels.

What we’re also seeing is how organizations respond to “impact.” Most responses are short-term, reactive measures designed to mitigate losses that do not always consider long-term risk.

- » Reduction in employment, via furloughs or terminations.
- » Reduction in salary and benefits to those who remain.
- » Elimination of contractor positions and/or vendors.
- » Cuts to non-core activities, including specialist, technical, and compliance support functions.

In times of extreme difficulty, management’s instinct is to cut costs to ease the impact on earnings. However, this strategy addresses only impact while doing nothing for risk. Such actions could make risks worse in the long-term. True risk management requires:

- » Assessing the impacts and the immediate response.
- » Understanding corporate risk tolerance in the face of significant disruption.
- » Developing strategies that align observed and potential impacts with risk tolerance and potential value and opportunity.



Companies may experience positive impacts with growth in sectors such as online shopping and delivery, telecommunications, video streaming, and home-office equipment. An organization's reputation may be improved because of its pandemic response efforts or its ability to adapt to new market needs.

Use the Right Resources

Risk management was never intended to be static. It's not a one-and-done exercise. Risk assessment and mitigation efforts evolve just as risk and risk tolerance evolve. Today, the world is experiencing an unprecedented confluence of risks and impacts. Reacting only to the impacts will likely leave a company unprepared for the challenges that lie ahead.

The Three Lines of Defense model has been widely adopted as a governance model for managing risks. Internal audit serves as the third line, reporting directly to the board. Higher risk areas — environmental, quality, IT, health and safety, supply chain — often have specialized programs, as part of the second line. These exist specifically because these areas are higher risk and require proper independent assurance, which internal audit can provide.

As organizations begin to visualize and prepare for a post-COVID-19 world, assessing risks and building risk-based audit plans must include people with expertise and skill sets best suited for these critical times. Balancing short- and long-term considerations and understanding the growing influence of ESG aspects will be critical to matching organizational needs with the right talent.



Quick Poll Question

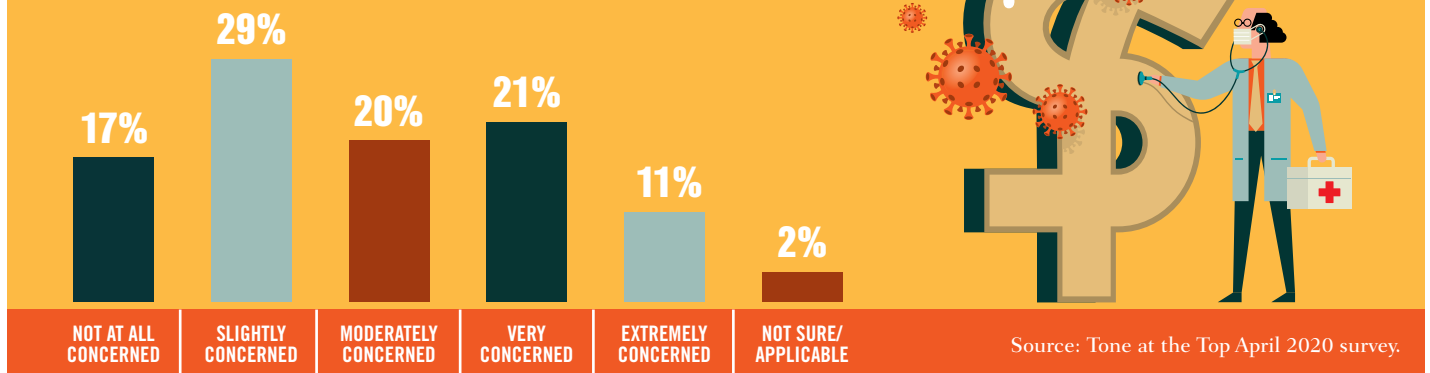
How are ESG issues being addressed as part of your organization's risk management discussions?

- Consistently
- Only for regulatory and compliance risks
- Just started since the advent of COVID-19
- Not addressed
- What's ESG?

Visit www.theiia.org/toner to answer the question and learn how others are responding.

QUICK POLL RESULTS

What is your level of concern about the long-term financial viability of your organization as a result of COVID-19?



Source: Toner at the Top April 2020 survey.

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