GLOBAL PERSPECTIVES & INSIGHTS

The ESG Risk Landscape

PART 1: Understanding ESG Reporting Standards in 2022 and Beyond

PART 2: Implementation, reporting, and internal audit's role

PART 3: Evaluating ESG Risks (Sponsored by EY)

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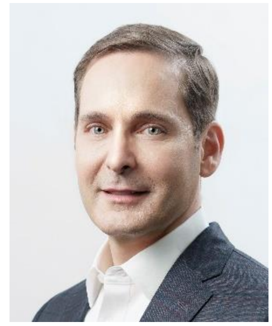

I'm excited to introduce you to the first edition of *Global Perspectives & Insights* in its new format, which is designed to help internal auditors by providing greater focus, clarity and direction in key risk areas. The new format brings together three themed Global Knowledge Briefs that delve deeply into a single topic, allowing for a robust and comprehensive examination.

As the title suggests, this inaugural edition focuses on *The ESG Risk Landscape* at a time when environmental, social and governance issues have captured the interest of regulators, investors and stakeholders like never before. The three-part series addresses:

Understanding ESG reporting standards in 2022 and beyond

Implementation, reporting, and internal audit's role

Evaluating ESG risks

Each part explores and builds upon the latest developments in this evolving and dynamic risk area. Collectively, they provide practical information to help you anticipate and prepare for new reporting regulations, position your internal audit functions to provide high-quality services, and offer direction on identifying ESG risks within your organizations. I encourage internal audit leaders to share *The ESG Risk Landscape* with their audit committees and executive management, as I believe it provides a valuable teaching tool on the important role internal audit can play in an organization's ESG journey.

This *Global Perspectives & Insights*, and those that will follow throughout the year, reflect The IIA's commitment to support our members around the world with timely thought leadership and insights. I believe it will help elevate your impact on your organization and add value as only internal auditing can.

Regards,

Anthony

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PART 1

Understanding ESG Reporting Standards in 2022 and Beyond

About the Experts

Deon Annandale, CA

Deon Annandale is the CAE and general manager of risk management and internal audit at Remgro Limited, a diversified investment holding company. In this capacity, he also serves as CAE for various investee companies in the Remgro Group, which involves independent engagements and mandates from the boards of those companies. Previously, Annandale was head of internal audit at Dorbyl Limited, and regional audit manager for BHP Billiton.

Luis de la Fuente, CIA, CRMA

Luis de la Fuente serves as head of internal audit for sustainability and ESG risks at BBVA, reporting to the chief audit executive of BBVA Group, a Spanish multinational financial services company. He has more than 20 years of experience in internal audit and has served as head of internal audit for BBVA Spain, BBVA USA, and BBVA Corporate & Investment Banking.

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Edward Olson is leader of environmental, social, and governance with MNP, a Canadian accounting, tax, and consulting firm. He also provides risk management, internal audit, corporate governance, and regulatory compliance services to private and public sector clients. Prior to joining MNP, Olson led the advisory services practice for a different Canadian public accounting firm. He also was the chief audit executive leading internal audit and risk management at a Canadian electric power and gas distribution/retail company, general manager for an alternative energy company, and partner in a firm where he acted as an outsourced CAE for clients in the financial services industry.

Introduction

Demands, necessity drive ESG interest

Environmental, social, and governance (ESG) issues are top priorities for companies, primarily driven by demands from stakeholders and governing bodies. These demands and the need for ESG and other non-financial reporting drives strategy, creation of financial value, and performance around non-financial parameters.

In particular, institutional investors are concerned about the impact ESG issues will have on risk and returns in the short, medium, and long term. Capital markets want relevant, accurate, comparable, and decision-useful information to inform their decision-making, and corporations are increasingly expected to incorporate ESG into their formal business processes. Other stakeholders expect reliable data and information to fulfill their own needs. All these demands pose risk — and opportunities — and create the need for developing a proper internal control environment for ESG with a key role for internal audit.

This knowledge brief discusses the major frameworks being used to manage ESG risk, along with regulatory concerns and reporting initiatives. The intent is to offer practitioners perspective on the ESG landscape and provide a roadmap for internal auditors as they solidify their role in their organizations' ESG journeys.

Note

Sustainability is a commonly used term, reflecting a general focus on environmental and social issues. This knowledge brief uses the term Environmental, Social, and Governance (ESG) to underscore the many categories under the ESG umbrella.

Internal audit has ability to address ESG issues

Providing assurance on non-financial reporting is not unfamiliar territory for internal audit — IT, talent management, or anti-corruption, for example, along with areas such as diversity, fall under the non-financial umbrella. Internal audit's tested and well-established processes over these areas provide a ready blueprint for addressing ESG-related issues.

Terms such as sustainability, corporate responsibility, and corporate social responsibility, along with non-financial reporting and ESG, are in common use and widely understood. It is important to recognize that ESG topics have always played a role in company risk, opportunities, and impact on performance and value. Areas that are part of ESG encompass:

- **Environmental,** which includes topics such as hazardous materials use, water and waste management, air quality, biodiversity, and habitats.
- **Social,** which includes occupational health and safety; right to organize; privacy; diversity, equity, and inclusion; fair wages; and other risk areas that may relate to the organization's relationship with its community.
- **Governance,** which includes roles, responsibilities, accountability, executive pay, and grievance mechanisms. It also includes being aware of the ways in which ESG requires a new model of leadership.

Some topics cross multiple categories. For example, climate change, while typically considered environmental, has social and governance implications, as does environmental justice. The COVID-19 pandemic vividly illustrates how a health and safety topic can affect all aspects of an organization, the supply chain, and the economy itself.

The United Nations' 17 Sustainable Development Goals[1] can provide broad categories for companies to use in developing their strategies. The UN goals include areas associated with ESG (such as clean water and climate action) as well as areas that can be considered part of sustainability (such as poverty, hunger, and gender equality). Some of the content of the various frameworks used in support of ESG governance reflects some of these goals, as well.

1. *The 17 Goals,* United Nations Department of Economic and Social Affairs, https://sdgs.un.org/goals.

Planning for the Future

Companies look to incorporate ESG into business models

Pace of change brings multiple challenges

A growing number of companies have incorporated ESG into their business strategies, objectives, and projects, including those that have announced goals for achieving net-zero (carbon) emissions. Some companies' goals align with the 2050 target in the Paris Accords (Barclays, Cemex), while other companies have set more ambitious targets of 2040 (PepsiCo, Sainsbury, VISA), and even 2030 (Apple, Burger King, Jacobs Engineering, Novo Nordisk). Generally, companies should develop strategies, programs, and controls to achieve their specific goals with the understanding that investors and other stakeholders will be holding them accountable.

In addition to net-zero initiatives, companies have committed to improving participation and equity for underrepresented groups in senior management and technical disciplines. Others have created entire business models around ESG differentiation, such as sustainably sourced lumber or green buildings. November's COP26 (Conference of the Parties) in Glasgow gave worldwide exposure and audience to the major ESG concern: climate change.

No single set of topics or metrics covers all ESG issues for all organizations. Furthermore, ESG is dynamic. Variations in stakeholder expectations, risks, and operations could cause some issues to take on higher profiles within a particular organization. As such, the approaches of organizations can differ somewhat, which can lead to reporting and disclosures that are not always comparable or useful to investors for decision-making.

New outreach, proposals, guidance, and standards in were seen on nearly every front in 2021, especially for users in capital markets. Even the organizations leading efforts for ESG reporting and disclosures changed, creating an array of new acronyms and uncertainty.

The U.S. Securities and Exchange Commission (SEC) announced in March 2021 the creation of a Climate and ESG Task Force[2] in its Division of Enforcement. Discussing the move, SEC Chair Gary Gensler said in July 2021 that investors support mandatory disclosures on climate change. As such, the SEC has indicated that new climate risk rules will require companies to detail and measure commitments to mitigating climate change.

The Sustainability Accounting Standards Board (SASB)[3] and the International Integrated Reporting Council (IIRC) merged in June 2021 to form the Value Reporting Foundation (VRF)[4] and unite ESG reporting frameworks. The VRF was short-lived; in November 2021, the IFRS Foundation announced formation of the International Sustainability Standards Board (ISSB)[5] and its plans to consolidate the VRF and the Climate Disclosure Standards Board (CDSB)[6].

The ISSB, a sister body to the International Accounting Standards Board, has the goal of driving globally consistent, comparable, and reliable sustainability reporting. The ISSB already has published two prototype standards, including one on disclosures related to climate change-related risks. It hopes to finalize its first set of standards by the end of 2022. The prototypes are fully supported by the International Organization of Securities Commissions, which is looking to evaluate and approve the disclosure standards by the end of

2.*SEC Announces Enforcement Task Force Focused on Climate and ESG Issues,* U.S. Securities and Exchange Commission, https://www.sec.gov/news/press-release/2021-42.
3. *SASB Standards,* Value Reporting Foundation, https://www.sasb.org/standards/.
4.*Resources Overview,* Value Reporting Foundation, https://www.valuereportingfoundation.org/resources/resources-overview/#integrated-reporting-framework.
5.*About the International Sustainability Standards Board,* International Sustainability Standards Board, https://www.ifrs.org/groups/international-sustainability-standards-board/.
6. *CDSB Framework,* Climate Disclosure Standards Board, https://www.cdsb.net/.

2022. Edward Olson, an ESG leader at Canadian accounting, tax, and consulting firm MNP, noted that while the EU is driving disclosure requirement changes, IOSCO's support of the ISSB prototypes as standards will drive mandatory reporting.

Meanwhile, the Global Reporting Initiative (GRI)[7], an ESG reporting framework for broader audiences, published revised universal reporting standards in October 2021. The GRI universal standards include a requirement for assurance, beginning with the 2022 reporting year.

7. *GRI Standards,* Global Reporting Initiative, https://www.globalreporting.org/standards/.

Tracking the Regulatory Environment

Capital markets’ concerns spur legislation

Change driven by more than ESG

History grants a few notable case studies that illustrate the global, rapidly evolving nature of ESG drivers. For example, the United Nations Universal Declaration of Human Rights was proclaimed by the UN in 1949, which led to dozens of human rights treaties addressing issues involving children, migrant workers, and rights of indigenous peoples. More recently, the UN General Assembly passed the UN Declaration on the Rights of Indigenous Peoples in 2007. There also are global initiatives to fight human trafficking, to commit to sustainable use and preservation of tropical timber, and much more. Guided by these global initiatives and treaties, countries, in turn, enact regulations to align themselves to the international viewpoint.

Such patterns are becoming more common across the ESG spectrum. For example, the 1989 Montreal Protocol addressed substances that deplete the ozone layer. Then, in December 2015, 195 countries signed the Paris Agreement, a legally binding international treaty on climate change, which entered into force in November 2016. As noted earlier, COP26 in November 2021 raised the profile of climate change even further.

Capital markets looking at value

The regulatory environment has responded to capital markets’ concerns with ESG risks (and opportunities) on financial performance in the short, medium, and long term. Three principal bodies of regulations from the EU drive ESG reporting and disclosures within its jurisdiction. Luis de la Fuente, head of internal audit for sustainability and ESG risks at BBVA, summarized them as follows:

1. The EU’s Corporate Sustainability Reporting Directive[8]: This will replace the EU’s Non-Financial Reporting (NFR) directive, which established high-level requirements, but fell short on guidance or expectations of implementation. The first set of standards from the EU are expected to be released by mid-2022. One expected change will be to move from non-financial reporting to “sustainability reporting” — which is broader and requires more quantitative reporting as opposed to qualitative. Disclosure by companies on how they influence the environment and community (“outbound”), as well as how the environment affects the community (“inbound”) will be expected. The new standards should also include a requirement for some external assurance of sustainability reporting.

2. EU Taxonomy[9]: This gives companies, investors, and policymakers direction on which economic activities can be considered environmentally sustainable. It has six objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy (recycling focused), pollution prevention and control, and the protection and restoration of biodiversity and ecosystems.

3. EU Data Strategy[10]: This is an effort to create a single market for data, allowing it to flow freely within the EU as well as across sectors. All countries can use the data; legislation for this will come later.

8. *Corporate sustainability reporting,* European Commission, https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en.
9. *EU taxonomy for sustainable activities,* European Commission, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en.
10. *European data strategy,* European Commission, https://ec.europa.eu/info/strategy/priorities-2019-2024/europe-fit-digital-age/european-data-strategy_en.

As noted, the U.S. SEC is taking a deeper interest in how organizations report climate and ESG-related disclosures to investors. The agency published guidance regarding disclosures related to climate change in 2010, and is expected to publish more rigorous proposed disclosure guidance in early 2022. The SEC adopted amendments to Regulation S-K (effective 9 November 2021), including the topic of disclosures on human capital resources.

The evolving regulatory landscape in Canada includes several actions. The Canada Securities Administration (CSA) issued Staff Notice 51-358 in August 2019, which gives public issuers, such as publicly traded companies, guidance on the disclosure of material climate change-related risks. In 2021, the Ontario Capital Markets Modernization Task Force called for more stringent climate-related reporting requirements. Beginning in 2022, Canadian Crown Corporations, which include the Bank of Canada, the Canada Post, the Public Sector Pension Investment Board, VIA Rail Canada, and others, will need to adopt the Task Force on Climate-related Financial Disclosures (TCFD)[11] reporting framework. Mandatory reporting will begin with corporations of more than $1 billion (Canadian) in assets and eventually extend to smaller corporations.

Regulatory authorities are monitoring how companies address these disclosure requirements. The CSA reviewed climate-related disclosures by large Canadian issuers and noted many boilerplate and incomplete disclosures. "The CSA's position is that these disclosures should be regarded as being for the issuers' own good — they help to understand asset loss exposures and highlight inefficient practices," Olson said.

National regulatory concerns

Jurisdictions at the national, regional, and local levels are enacting regulations over ESG topics.

The United Kingdom passed the Modern Slavery Act in 2015. It requires companies above a specified threshold of sales in the United Kingdom to address modern slavery in their organizations and supply chains, as well as publish related annual reports. Conflict minerals rules in the EU and U.S. also require due diligence, and (for public issuers in the U.S.) reporting. Canada addressed governance directly with an amendment to the Canada Business Act that explained the "fiduciary duty" of the board. Bill C-97 (2019) expressly stated that directors should consider the interests of other stakeholders (creditors, the government, as well as environmental concerns) in addition to company shareholders.

South Africa

South Africa is one model for an enlightened approach to ESG reporting and disclosures, said Deon Annandale, who is the CAE and general manager of risk management and internal audit at Remgro Limited, a diversified investment holding company. The King Code[12] on Corporate Governance, now in its fourth revision, lays out a governance and reporting model and codifies integrated reporting. In addition, the Johannesburg Stock Exchange signed the UN-backed Sustainable Stock Exchanges Initiative in 2012 and has listing requirements for companies trading on the exchange. These initiatives gave South Africa a head start on improving systems and controls for ESG topics.

In addition, ESG parameters such as diversity and inclusion goals and energy use also are being incorporated into government contracts. The U.S. government requires companies doing more than $8.5 million in contracting with federal agencies to disclose whether they publish a Greenhouse Gas Emissions inventory report for Scope 1 and Scope 2 emissions, as well as provide a link to a website where it is publicly available.

11 *TCFD Recommendations,* Task Force on Climate-related Financial Disclosures (TCFD), https://www.fsb-tcfd.org/.
12.*King IV Summary Guide,* KPMG, https://assets.kpmg/content/dam/kpmg/za/pdf/2016/11/King-IV-Summary-Guide.pdf#:~:text=King%20IV%E2%84%A2%20is%20structured%20as%20a%20Report%20that,and%20recommended%20practices%20aimed%20at%20achieving%20governance%20outcomes.

EU financial-sector initiatives

In addition to the overarching EU drivers, five other initiatives are applicable to the EU's financial sector, de la Fuente said. They are:

1. EU Sustainable Financial Disclosures Regulation[13]: This rule, which took effect in March 2021, establishes transparency and sustainability-related disclosure requirements on the financial services industry. The disclosures cover products such as mutual funds, mortgages, and insurance in an effort to prevent greenwashing.

2. Initiatives from the European Banking Authority[14]: These include an action plan on sustainable finance, as well as a roadmap of their regulations. The authority has provided guidance on loan origination and management and is working on integration of ESG risks for credit institutions.

3. Two initiatives from the European Central Bank[15]: One involves expectations on how to manage climate risk, which de la Fuente noted is not very different from the guidance recently released by the U.S. Office of the **Comptroller of the Currency**[16], while the second involves a stress test exercise for various scenarios such as drought or flooding.

4. Markets in Financial Instruments Directory II (MiFID II)[17]: This regulates financial markets in the European Union and improves investor protections. Stocks, commodities, debt instruments, futures and options, exchange-traded funds, and currencies all come under its oversight.

5. EU Green Bond Standards[18]: The voluntary standard, adopted in July 2021, is intended to help support the growth of the green bond market and promote transparency and integrity, as well as reduce the risks of greenwashing.

The ESG regulatory environment "is very fluid and changing all the time," de la Fuente said. However, this has not slowed regulatory bodies from moving ahead. While there is no single globally accepted standard at this time, the frameworks in use are generally similar. Doug Hileman, a consultant in compliance, operations, auditing, and nonfinancial reporting, agreed, noting that concepts and provisions from one framework tend to show up in others. In the early days of EU's NFR directive, about half the downloads of SASB standards came from outside the U.S. Many provisions of TCFD look familiar to preparers and analysts of companies that have provided robust disclosures of climate change-related risk in SASB standards.

De la Fuente added, "This uncertainty and the lack of final criteria can be unsettling both to corporations and to internal audit, and used as a reason not to move forward. But inaction until regulations are finalized is simply an excuse. Pick a framework, identify elements that apply to your organization, and get a head start."

13. *Sustainability-related disclosure in the financial services sector,* European Commission, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/sustainability-related-disclosure-financial-services-sector_en.
14. European Banking Authority, https://www.eba.europa.eu/.
15. European Central Bank, https://www.ecb.europa.eu/home/html/index.en.html.
16. *Climate,* Office of the Comptroller of the Currency, https://www.occ.gov/topics/supervision-and-examination/climate/index-climate.html.
17. *MiFID II and the integration of ESG factors,* STRATECTA, https://www.stratecta.exchange/mifid-ii-and-the-integration-of-esg-factors/.
18. *European green bond standard,* European Commission, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/european-green-bond-standard_en.

Choosing Reporting Frameworks

Frameworks emphasize different areas

Choosing can be daunting to companies and capital markets

Companies have various frameworks to choose from in developing their ESG reporting, some of which are oriented towards the expectations of capital markets. They include:

- **Sustainability Accounting Standards Board (SASB)**:[19] This focuses on a selected few disclosures relevant to a company's overall sector and is geared toward an investor audience. The material topics and disclosures are suggested by SASB for each of 77 noted industries.
- **International Integrated Reporting Council (IIRC)[20] Integrated Framework**: This framework supports development of integrated reports on an organization's strategy, governance, performance, and prospects in the context of its external environment; and how it leads to the creation, preservation, or erosion of value over the short, medium, and long term. (The council formed in 2010, and the framework was published in 2013.)
- **Task Force on Climate-related Financial Disclosures (TCFD)**[21]: The TCFD introduced its reporting framework in 2017, which focuses solely on climate-related financial risk. The goal of disclosures according to this framework is to align to investors, lenders, insurers, and other stakeholders' expectations.
- **World Economic Forum (WEF)**[22]: The WEF, in coordination with the Big Four accounting firms (Deloitte, EY, KPMG, and PwC), developed ESG metrics based on leading practices from existing frameworks. These metrics were published in hopes of hastening convergence among the leading private standard-setters, which might bring greater comparability and consistency to the reporting of ESG disclosures. (The WEF released its standards in 2020.)

Organizational developments in the 2021 re-shaped some of these frameworks. SASB and the IIRC merged in June 2021 to form the Value Reporting Foundation (VRF)[23], with the aim of providing more consistency in standards and frameworks. Within five months of VRF's creation, the IFRS Foundation consolidated it with the Climate Disclosure Standards Board to form the International Sustainability Standards Board (ISSB)[24].

In addition, the IFRS Foundation formed the Technical Readiness Working Group (TRWG)[25] to begin developing global sustainability disclosures standards for capital markets. As noted earlier, two prototypes (general and climate change) were released when ISSB's creation was announced in November 2021.

Other reporting frameworks include:

19.*SASB,* Value Reporting Foundation https://www.sasb.org/standards/.

20. *International Integrated Reporting Framework,* Value Reporting Foundation, https://www.integratedreporting.org/resource/international-ir-framework/.

21.*TCFD Recommendations,* TCFD, https://www.fsb-tcfd.org/.

22. World Economic Forum, https://www.weforum.org/.

23. *Resources,* Value Reporting Foundation, https://www.valuereportingfoundation.org/.

24. *About,* International Sustainability Standards Board, https://www.ifrs.org/groups/international-sustainability-standards-board/.

25. *Technical Readiness Working Group,* IFRS, https://www.ifrs.org/groups/technical-readiness-working-group/.

- **Global Reporting Initiative (GRI)**:[26] The GRI — the most widely used standard — was designed to increase disclosures on a wide range of ESG issues and topics relevant to stakeholders; companies select disclosure topics based on a stakeholder inclusive materiality analysis.
- **Climate Disclosure Project (CDP)**[27]: This organization focuses on climate reporting, energy strategy, and climate change. The CDP also has initiatives for cities and public entities to report on water use and supply chain management.
- **Greenhouse Gas (GHG) Protocol**[28]: This provides a standard framework for carbon accounting and reporting greenhouse gas emissions.

In addition, tools such as backcasting, which is used in sustainability planning, and models such as the sustainable business model canvas can help companies formulate their organizational strategy, said Charlotta Löfstrand Hjelm, chief internal auditor at Länsförsäkringar AB, a Swedish insurance and banking company.

Recent developments and dynamics

Hileman said his clients use most of the recognized frameworks, such as GRI for corporatewide ESG reporting on a variety of topics, SASB for ESG topics in financial filings to the U.S. SEC, and the TCFD for climate change-specific disclosures. Clients also use the GHG Protocol for GHG emissions calculations, as well as the basis for reporting this parameter via other channels. They might even use frameworks specified or implied in regulations regarding issues such as conflict minerals and modern slavery — some because they are regulated directly, and others to meet requirements of their customers.

Remgro's reporting structure is evolving, Annandale said. The company uses elements of the GRI in its non-financial disclosures along with guidance and principles from the IIRC Integrated Reporting Framework. As part of a groupwide project, the company also is looking at other recognized frameworks such as SASB's and CDSB's as the group's strategy, goals, targets, and metrics continue to mature. Factors involved include management of these issues, investment philosophy, and its external reporting process. An outside consultant is assisting in this project.

BBVA combines financial and non-financial reporting using the GRI as well as standards from other frameworks, de la Fuente said. This integrated report goes to regulators and shareholders. BBVA also uses the TCFD for a separate report on climate change that is not submitted to reporting agencies but is posted on the bank's website.

26. *GRI,* Global Reporting Initiative, https://www.globalreporting.org/standards/.
27. CDP (Climate Disclosure Project), https://www.cdp.net/en.
28. Greenhouse Gas Protocol, https://ghgprotocol.org/.

Conclusion

Internal audit faces risk and opportunity

Clearly, the ESG reporting landscape is complex and — in light of recent developments to establish global reporting standards — evolving. As assurance providers for their organizations, internal auditors already are tasked with continually monitoring a multi-faceted risk landscape that includes fraud, cybersecurity and IT-related risks, stringent financial reporting standards, data privacy risks, talent management, and much more.

The breadth of the ESG risk landscape necessitates a wide knowledge base, and this, combined with internal audit's known experience navigating various reporting standards (e.g., SOX), makes the audit function a natural fit in supporting the organization's response to the world's ever-increasing ESG focus.

This provides an opportunity for internal audit to reinforce its importance to the organization's strategic plan. However, without adequate preparation and ongoing learning, the consequences of negligence or inaccuracies in this role can be significantly damaging — both to the organization and to the credibility of the internal audit function.

As with any risk, the goal of ESG reporting is not to reach a finite end point. Rather, the organization should seek a level of maturity where it can remain vigilant and proactive. The risk itself never "ends" in the traditional sense, but the risk is largely mitigated though a nimble, thorough strategy aligned across reporting lines and with the expectations of the society in which the business operates. The first step to reaching that maturity is to understand the shape of the current ESG landscape with a degree of foresight to what may develop. Part 2 of this series will cover in detail internal audit responsibilities in this evolving ESG landscape, while Part 3 will provide strategies for how internal auditors can evaluate ESG risks within their own organizations.

PART 2

Implementation, reporting, and internal audit's role

About the Experts

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Introduction

There is little argument that environmental, social and governance (ESG) risk has become a permanent part of the modern risk lexicon. The need for independent assurance on the design and efficacy of ESG-related processes and controls will soon be essential to the work of internal audit. Just as evolving risk has expanded the profession's scope of services beyond financial reporting to include compliance, operational, and cyber risk, so too will it be for ESG-related risk. As such, internal auditors must be prepared to act confidently and authoritatively in support of their organizations' ESG efforts, particularly in instances where such efforts are new to the organization.

The challenge for many practitioners will be how to deliver high-quality assurance and advisory services that add value in a risk area that is quickly evolving on several fronts, including:

- Understanding the scope of ESG risks.
- Implementing models and frameworks for related controls and processes.
- Overcoming uncertainty about reporting and reporting standards.
- Managing ESG risk holistically across the organization.

Strong organizational governance over all aspects of ESG risk, from data governance to reporting, should drive internal audit's work in this area. This requires alignment in roles and responsibilities among the board, executive management, and internal audit as outlined in The IIA Three Lines Model[29]. The following provides an overview of internal audit's responsibilities relating to providing objective assurance, insight, and advice on effective ESG practices, risk management, and reporting. It should be considered in conjunction with parts 1 and 3 of *The ESG Landscape* series published by The Institute of Internal Auditors.

29. *The Three Lines Model,* The Institute of Internal Auditors, https://www.theiia.org/globalassets/documents/resources/the-iias-three-lines-model-an-update-of-the-three-lines-of-defense-july-2020/three-lines-model-updated.pdf.

Implementing ESG

Evaluate current status as a starting point

Several models are available for designing, implementing, and evaluating ESG programs. Even a cursory internet search will turn up models from the prominent audit firms, accounting and professional service firms, IT/software vendors, professional organizations, and academic organizations.

Each emphasizes different points and approaches, but the underlying principles and concepts should look familiar to internal audit practitioners and their stakeholders. For example, COSO's Enterprise Risk Management Framework and its Internal Control – Integrated Framework are agnostic with regard to topic. They are adaptable to risk management and external (ESG/sustainability) reporting, respectively. ISO management systems standards and others follow the familiar cycle of plan, do, check, and act.

As a first step toward implementation, organizations need to take stock of what is already in place, said Doug Hileman, a consultant in compliance, operations, auditing, and non-financial reporting. Many ESG topics are well established and are regulated by a variety of agencies globally. For example, in the United States, the Environmental Protection Agency, Occupational Safety and Health Administration, Department of Labor, Department of Commerce, and other agencies have established regulatory and reporting regimes. However, reporting in such areas has been done primarily to fulfill regulatory requirements.

Many companies use ISO management systems to formalize processes in ESG topical areas, including environmental, safety, and energy management. Some companies have extended coverage of management systems to include some content included in ESG reporting. Still, these management systems may not rise to "investment grade" internal controls expected by capital markets.

Remgro, BBVA: Putting ESG assurance to work

Enterprise-wide risk management at Remgro Limited, a South African diversified investment holding company, is based on COSO's ERM framework, said Deon Annandale, CAE and general manager for risk management and internal audit. The internal controls process and environment also are aligned and assessed based on the COSO Internal Control– Integrated Framework. These frameworks form the foundation for Remgro's approach to ESG risk management and reporting, he said.

As a financial services company, BBVA is heavily regulated and supervised, said Luis de la Fuente, the Madrid-based bank's head of internal audit for sustainability and ESG risks. Rather than focusing only on reporting, internal audit at BBVA has a strategic goal in making sure the company manages its risks properly. BBVA has embraced sustainability as a core part of its strategy, he said. Internal audit accompanies the business units through their maturation process. This automatically helps align interests between business lines and internal audit, because by taking the lead in sustainability, the bank also minimizes its ESG risk.

A company may find that various components of ESG are in different stages of maturity, having originated in different parts of the organization. Hileman suggests cross-functional teams are an excellent way for departments, including HR, Investor Relations, and Operations, to build common understanding of issues, risks, stakeholder expectations, systems, and controls. COSO's internal control framework has relevance for ESG reporting, Hileman said. In early days of the U.S. Sarbanes-Oxley Act of 2002, companies found they had strong programs in some areas, but room for improvement in others. It is the same situation now for ESG reporting, but it may be more difficult this time for several reasons, he said. First, ESG reporting is not as mature as financial reporting was when Sarbanes-Oxley was passed. Second, ESG covers many topics, with homes in different parts of the organization, which historically have not communicated with each other about topics within their own specialty. In addition, the need is new for reasonably consistent internal systems and controls that are sufficiently robust to support external reporting to capital markets.

Ensuring Completeness and Accuracy

Robust management systems are important factor

As with any risk area that involves public reporting, internal audit should play a critical role in ensuring data completeness and accuracy. The likely assurance requirements that will be part of the European Union's Corporate Sustainability Reporting Directive, along with hints of the same from the recently created International Sustainability Standards Board (ISSB), underscore the expectations for complete and accurate ESG data. Still, challenges exist in ensuring the completeness and accuracy of data and information. This can be expected, Hileman said, given where this data originates (HR, Environmental, Procurement, Sales, etc.) and how their systems and controls developed independently.

Additional challenges stem from parameters of some ESG topics extending beyond the boundaries of the organization and into diverse areas that stakeholders expect them to influence. Increasingly, shareholder expect diversity and inclusion requirements to extend to contractors. As another example, the Greenhouse Gas Protocol's Scope 3 emissions include supply chain, transportation, product use, and disposal, which are often the largest contributors to greenhouse gas emissions yet operate outside the purview of many organizations.

The risks associated with meeting public expectations on managing third-party ESG matters can quickly meet the well-established bar of "likelihood and impact." One high-profile retailer suffered reputational damage when it became known that the landlord's parking system used an app that tracked customers' browser usage. The retailer's explanation that it was not in control of the app fell flat. This lack of boundaries is in contrast to the rigid boundaries that exist for financial reporting, which have been established for years and are subject to regulation and accounting practices.

This kind of situation is all the more reason for companies to focus on ensuring — or building — robust management systems with a strong control environment that require the same rigor as controls over financial reporting, said Edward Olsen, an ESG leader at Canadian accounting, tax, and consulting firm MNP. The criteria for some controls are well developed, such as for Scope 1 and Scope 2 greenhouse gas emissions. Internal audit has relevant experience and is well positioned to help companies in these areas, he said.

At Remgro, the board established, through its audit and risk committees, a combined assurance process designed to ensure all relevant and reportable non-financial information is assessed for completeness, accuracy, validity, and relevance, Annandale said. External consultants validate data used in submissions on environmental impact to the CDP, for example. The processes at both Remgro and its subsidiary companies include comprehensive control processes, technology, and reporting systems; validating reports that have been generated; and control assessments by internal audit and consultants. Reports generated at individual company levels and reported up to Remgro are reviewed by the responsible C-suite-level officers, who sign off on the controls, environment, and processes used to generate the reports.

Risks Associated With ESG Reporting

Lack of strong controls can cause problems

The risks associated with ESG reporting mirror those of financial reporting, Hileman said. The content of the reporting may be incomplete, inaccurate, not supported, or not verified. Alternatively, the content may be altered by unauthorized parties, perhaps intentionally for some type of gain, such as a reducing capital costs for green investment instruments or gaining advantage in a government contract.

Annandale said the primary risk from ESG reporting is to corporate reputation. There is always the risk that the focus on frameworks and tick-box approaches could overshadow and become misaligned with the board's strategic intent. The intent of ESG reporting is to ensure that Remgro and its companies make responsible investment decision, Annandale said. Integrity and stakeholder trust is fundamental to the whole process, he added.

Other risks include:

- Compromise of the credibility and usefulness of the reporting process if inappropriate indicators and/or frameworks are used in aggregating and reporting information.
- Invalid and misleading information stemming from inadequately designed controls and systems.
- Compromises to credibility because of overly optimistic assumptions in setting targets.
- Reporting beyond the minimum standards and raising stakeholder expectations that may not be met in practice.

Regarding ESG, Annandale said disclosures need to avoid the risk of non-compliance, and at a minimum need to be compliant with legal requirements. The Johannesburg Stock Exchange is moving toward mandatory disclosure, having launched ESG disclosure guidance in December 2021.

Other risks include:

- General misalignment risk, where ESG reporting is inconsistent with other financial disclosures or corporate communications.
- ESG is seen as a 'box-ticking' exercise. This is a strategic risk because the underlying goal of the ESG policy is to drive a transition to sustainability. Meeting this goal implies business innovation and perhaps changes to core activities, strategies, and even business models.
- ESG is seen as marginal rather than central to a company's activities.

De la Fuente said the main risks are errors, both intentional and unintentional. He noted that controls in ESG reporting and non-financial reporting are not as robust as those for financial reporting, have a shorter history, and generally are not being reviewed by an external firm. Internal audit can provide value by reviewing the controls, he said.

However, both banks and other businesses face a number of risks if they are not successful in understanding and managing ESG issues, de la Fuente said. They include:

- Impact on business model. Investors likely will push publicly listed companies to adopt sustainability practices. Companies not attentive to ESG issues could lose their competitive position.
- Limitations on sources of capital, or higher costs for capital.

- Regulatory risks.
- Demands for corporate responsibility from employees as well as customers.
- Harm to a company's ability to attract customers and employees, who expect companies to imbed ESG factors into their business.
- Social and geopolitical implications, such as localized social or civil unrest.

Roles of Internal Audit

Unique perspective allows a systematic approach

Internal audit has clear roles in providing assurance and advisory ESG services, and its experience and place in the organizational structure suggests even more roles that can add value to the organization. Internal audit's unique position within the organization allows it to help guide it to a systematic approach to ESG, embrace the coming changes, and put sustainability goals and theories into practice.

Assurance

Internal audit at BBVA tries to provide both assurance and advisory services, especially on governance, de la Fuente said. Factors under consideration include how the company sets its strategy, how sustainability is considered in the business model, whether roles and responsibilities are clear, and whether good reporting to the board has been established.

Internal audit is paying attention to these areas now because eventually, with a little more maturity, it will be able to provide assurance to products and processes, he said. Governance, environmental issues, and reporting disclosures are the bank's main priorities right now, which reflect European priorities, de la Fuente said.

Although ESG systems and controls are not "assurance ready" for many aspects of assurance, the demand for external assurance from capital markets is undeniable. Internal audit should pre-emptively gear up to fulfill a role for ESG reporting to capital markets, just as it did for internal controls over financial reporting in the wake of Sarbanes-Oxley. Otherwise, companies will be faced with external auditors looking at ESG systems and controls before they are mature and without internal audit having a first look.

De la Fuente listed several ideas on how internal audit can begin offering advisory services if a company is just getting started in ESG. First, do not look at areas where regulations are in place or where policies and procedures have been established for some time, because sufficient criteria already exist to perform assurance over those areas. Instead, initiate management discussions in areas that are less defined and not ready for assurance, such as those involving guidelines or expectations from regulators, he said. Non-financial reporting, voluntary frameworks and supervisory guidelines (not rules) are great opportunities to help improve governance and risk management through advisory engagements. "We test the waters on the topic. We focus on issues that are emerging," de la Fuente said. However, management approves all engagements.

Annandale said internal audit is ideally placed to be a major assurance provider in the ESG and non-financial reporting process. Internal audit has deep corporate knowledge and per its mandate already assesses culture, ethics, governance frameworks and processes, internal reporting, combined assurance, internal control, control environment, and compliance. What's more, it has knowledge of fraud and related risk.

Internal audit leaders and practitioners should recognize that ESG-related assurance engagements will come to them, Hileman said. Once external assurance is required by a law, regulation, or standard, the board can be expected to turn to internal audit for assurance ahead of work by the external auditors. "This is why IA should discuss this with the board and management, and develop the pathway to assurance," he said.

Advisory

Internal audit should advise on the risk landscape of ESG as it pertains to reporting to capital markets, competitive advantages and disadvantages, compliance (as broadly defined), operational efficiency and effectiveness, and reputational risk. This role lends itself to advisory efforts as issues evolve, de la Fuente said. Internal audit can play a useful role from start to finish by identifying the issues, having discussions with management and the board, planning, getting the pulse of organization's readiness and opportunities, and providing insights to reduce risks and leverage opportunities. This goes to the heart of the company's ESG strategy and success — or failure.

Advisory engagements can help the organization understand risk, focus on the right issues, and chart their path forward. Internal audit should use their familiar planning skill sets to identify topics, socialize them with management and the board, and build reasonable consensus for advisory engagements. Once these are done audit procedures will look much like any other audit.

In addition, there are advisory work opportunities including, benchmarking, strategy and appetite considerations, framework selection considerations, KPI development, resource requirement assessment, reporting considerations, and assessing the overall benefits of sound ESG practices.

Internal audit also can embrace other roles that can add value to an organization's ESG journey without compromising independence or objectivity.

- **Advocacy:** ESG topics traditionally are widely dispersed in an organization, and there may be no single point of contact for external ESG reporting and disclosures. When it does have a home, it may be a function without authority, resources, or skills to fulfill this important activity. Internal audit can advocate for the company to approach ESG just as it would approach any other risk: seriously. Internal audit also should advocate for its own role in the pathway to assurance.
- **Convener:** If internal audit has not had discussions with the board on ESG, it should initiate these. Internal audit should be involved in all such discussions. Internal audit can suggest or evaluate cross-functional teams, convening functions in the organization that should be involved in ESG strategy, reporting, disclosures, and risk management consistent with business strategy and goals.
- **Capacity building:** Internal audit should build its own capacity. This can be internally, with co-sourcing, or using external resources – including ESG specialists. Internal audit may identify insufficient capacity to manage ESG risks and opportunities at the organization; these insights can serve as advocacy to justify capacity in first or second lines of governance.

The only way to advance is by asking for information, analyzing the data, and initiating discussions with management. Management, "wants to do a lot of things; they don't have the time, and they don't know where to start," de la Fuente said. This is where internal audit has a crucial role to play, he said.

Skill Sets for Internal Auditors

Knowledge of financial auditing transfers to ESG

Auditors with a background in financial auditing have the skills to do non-financial auditing, although they may need training on some issues, such as regulations applicable to their particular country and knowledge on ESG analysis, de la Fuente said. The CFA Institute's certificate in ESG Investing as well as the ESG Analyst certification offered by the European Federation of Financial Analyst Societies (EFFAS) can serve as an entry point into ESG auditing for auditors who already have the background in financial reporting. These certificates provides a financially viable opportunity to add ESG knowledge and skills for smaller audit functions, which typically cannot afford to hire engineers or engage consultants, de la Fuente said.

Internal auditors can build off the skills they use elsewhere, said Hileman — curiosity, professional skepticism, courage, persistence, knowledge of the organization, familiarity with the subject matter (or the assistance of someone who is familiar), as well as communications skills. It also would be helpful for internal auditors to have some background on the history and rapid evolution of ESG reporting — the expectations, risks, and opportunities. Internal audit also should develop a comfort level with advisory engagements, he said. While the front end of such engagements —identifying topics, having discussions, developing a consensus, planning — look different, the engagements themselves should look and feel familiar.

Annandale said that in addition to the skills already required from proficient internal auditors, consideration should be given to:

- Effective, influential, and inspirational communication.
- Governance best practice.
- Technology driven assurance processes in non-financial data.
- Trusted advisor attributes.

Internal auditors have the time to train and to think about such areas as sustainability issues. In addition, internal audit can help management be more aligned with its strategy and to be more effective, de la Fuente said. For example, if BBVA is successful in deploying a sustainability strategy and in helping its customers become more sustainable, it in turn will become more effective at mitigating ESG risks, he said.

In addition, ESG technical specialists can add value to internal audit and to organizations themselves. Annandale noted these skills complement the skills of auditors, while de la Fuente said technical specialists would be especially useful for small audit shops, which may not be able to afford to hire in-house specialists. Added Hileman: "ESG is not a monolith. Climate change, work force equity, forced labor in a supply chain, habitat preservation, and privacy are very different. Some assistance can be useful in establishing priorities and programs at a high level."

Closing Perspectives and Tips

Deon Annandale

At Remgro, governance authority for ESG is vested in the board of directors. The board in turn established a strategic ESG committee that reports to the board, along with an ESG operational committee that reports to Remgro's board. The board's remuneration committee links KPIs for the ESG process to the achievement of various performance indicators.

Integrated thinking (about both financial and non-financial concurrently) offers another window on more effective risk management and value creation. Remgro applies COSO"s ERM to ESG risks. This allows it to integrate ESG principles and practices into the company's broader ERM framework. In addition, Remgro uses PESTLE[30] (Political, Economic, Social, Technological, Legal, and Environmental) analysis as a framework to assess emerging risk and opportunities.

Luis de la Fuente

Internal audit should first help organizations understand how ESG applies to them, not just for compliance and risk management. Reporting is the first thing audit functions should be incorporating into the program for ESG.

De la Fuente underscored the importance of data, as well as the need to be proactive. From an auditing perspective, when addressing social related issues, "I think it is important to sit at the table with management with abundant data." Using data supports internal audit's case rather than simply discussing generalities. "I think it's important that you do your math and crunch the data and have some ideas to throw to management."

BBVA's internal auditors adopted one simple convention that has improved engagement with their internal stakeholders: Internal audit does not assign a rating on an advisory engagement. Instead, they issue recommendations, do a follow-up, and wait at least 12 months before considering a "rated audit." Internal audit understands that, as an emerging issue, many elements of risk management and internal controls likely will be lacking, and a traditional rated audit would consider those as gaps or deficiencies, resulting in a "bad grade." This, in turn, can influence mangers' compensation, reputation, and chances for promotions, which is hardly the way to encourage auditees to provide full, truthful information. These advisory engagements are an opportunity for insights and help, de la Fuente said.

De la Fuente mentioned the forward-looking thrust of ESG programs and reporting. Internal audit can play a role in value creation. Because banks play a central role in the economy, this value — financial and otherwise — extends beyond the bank into communities and the overall economy for a more sustainable world.

Doug Hileman

Hileman noted that the term "greenwash" is common and said internal auditors should go further and consider ESG fraud, which may not look like the usual misappropriation of assets. Data analytics (Benford's law, etc.) may not be useful in the traditional sense, but it will evolve. Insist on a fraud brainstorming session for any type of ESG effort – planning, advisory, assurance, or advocacy, and become a champion for prevention and detection of ESG fraud.

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30. *What is a PESTEL Analysis?* Oxford College of Marketing, *Oxford College of Marketing*, https://blog.oxfordcollegeofmarketing.com/2016/06/30/pestel-analysis/.

Hileman also noted that many organizations have second-line audit functions such as IT, environmental, quality, or safety with staff and systems IT platforms that can be adapted to the current demand for ESG information. However, many of these second-line audit programs remain mired in their original purpose. They typically have not had a quality assurance review, and many focus exclusively on regulatory compliance, not on other risks (including external ESG reporting to capital markets). Internal audit should take the initiative to improve and leverage these resources, being careful to monitor and recognize the appropriate separation of second- and third-line responsibilities, as outlined in The IIA's Three Lines Model.[31]

Finally, Hileman noted that ISO management systems standards initially focused on "training," but have changed to "competence" in recent revisions — a subtle, but important difference. The high profile of ESG has led to an influx of ESG professionals with areas of focus as broad as ESG itself, from green buildings to renewable energy or sustainable textiles. While many of these ESG professionals are competent, some entered the field driven by passion and offer less value to organizations looking to mitigate risk and create value. Be discerning in resourcing decisions and invest in conferences, useful certifications, continuing education, and coaching to ensure that employees can contribute to the success of ESG audits and programs.

Edward Olson

Olson emphasized the need for tailoring ESG implementation to each organization. Risks, opportunities, and requirements vary by industry, geographic location, regulatory environment, policy environment, and a host of other drivers and influences. Other companies' programs can provide useful precedents, and vendors offer "solutions" – but all will require customization.

Olson also notes a different kind of accountability. ESG disclosures include targets, and the reporting frameworks require the inclusion of prior years' performance on these parameters. Analysts and capital markets will follow these and will hold management and boards accountable for their progress (or lack thereof). Failure to achieve targets or simply making boilerplate disclosures on how the company attempted to achieve the targets can have ripple effects from financial institutions, customers, or other stakeholders.

Finally, Olson put a different twist on a classic step in risk management. One option to address risk is always to "do nothing" and accept the risk posed by the current condition. The degree of attention on ESG, the pace of change, and the very public nature of ESG reporting and disclosures all point in one direction: Do *something*.

31. *The Three Lines Model,* The Institute of Internal Auditors.

PART 3

Evaluating ESG Risks

About the Experts

Michelle Uwasomba

Michelle Uwasomba is a principal in the Consulting Enterprise Risk practice of Ernst & Young LLP (EY US) with more than 17 years of experience leading major strategic, risk, ESG, and resilience program transformations globally. Uwasomba helps EY clients harness value through strategic risk management over enterprise and program portfolios, and she also has proven experience working in energy risk management at a multinational professional services company and as a corporate and program risk manager overseeing a US$2.25 billion portfolio.

Shannon Roberts

Shannon Roberts is a principal in the Climate Change and Sustainability Services practice of Ernst & Young LLP (EY US). She is a passionate sustainability and environmental, health and safety (EHS) professional with a BS in Chemical Engineering and 15 years of proven technical experience across sectors. Shannon currently leads an EY team of professionals supporting clients in achieving their ESG goals in environmental impacts, including climate risk; decarbonization; circular economy and product stewardship, including heatlh and safety and diversity, equity, and inclusion (DEI); and governance, including operating model and risk manageent. She provides ESG services to major companies in strategy, culture transformation, risk management, operational excellence, supply chain, audit, digitalization, and reporting services.

Introduction

A tangled ESG web

As discussed in previous iterations in this series, the Environmental, Social, and Governance (ESG) landscape is vast, containing a large number of topics which an organization must manage as part of its business strategy to better align with the expectations of today's stakeholders. Established subjects that fall under one or more elements of ESG include:

- Climate change, greenhouse gases (GHGs), waste management, and biodiversity ("environmental").
- Diversity, equity, and inclusion, and worker health and safety ("social").
- Organizational roles, responsibilities, and accountability measures ("governance").

Additionally, as ESG market and regulatory expectations mature for each individual topic, it is becoming clear just how complex the greater ESG conversation truly is. Climate change, for example, which is currently a focus for global regulatory reporting, has significant societal implications that go far beyond environmental concerns. Indeed, organizations must also consider the social and governance implications of managing climate risk and decarbonization. As a result, key stakeholders, including investors (and related ESG ratings agencies), customers, and employees have accelerating expectations; global industry standards are emerging and maturing; and global regulations are being proposed. Each vary and influence the ways a company must manage and report on this risk. Accomplishing this will require risk evaluation and assurance providers within organizations to take a comprehensive, ever-evolving strategic approach. Without this, the ability for organizations to achieve goals and operational performance aligned with accelerated market and regulator expectations will be compromised.

With this challenge in mind, this third and final part of *The ESG Risk Landscape* series will discuss how internal auditors can better identify and evaluate ESG risks within their own organizations, as well as provide some real-world strategies employed by internal audit functions currently in the field. To aid in this task, Michelle Uwasomba, Principal, Consulting Enterprise Risk Practice, and Shannon Roberts, Principal, Climate Change and Sustainability Services Practice, of Ernst & Young LLP (EY US) agreed to share some of their experiences in supporting companies in the development and execution of management programs to identify, assess, and respond to ESG risks (both upside and downside).

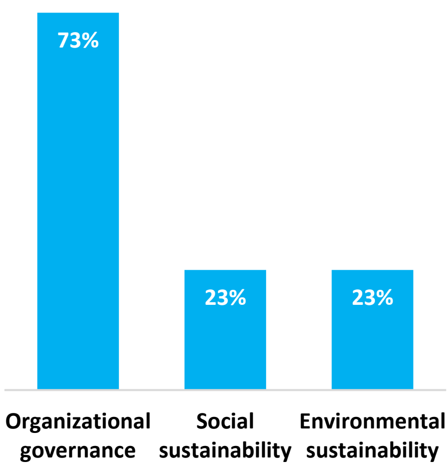
ESG Awareness in 2022

Progress in some areas, not others

Awareness but unease

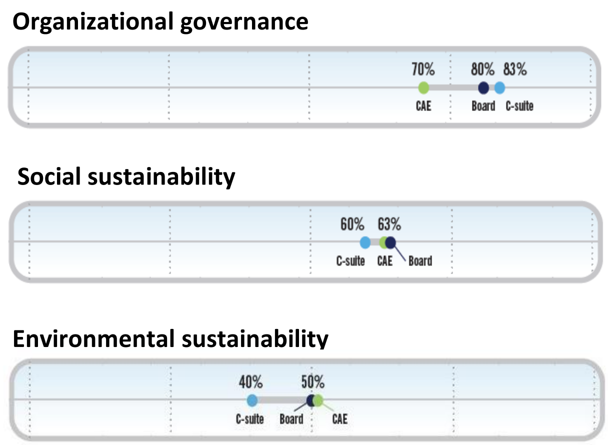
Although the increasing prominence of ESG on the international stage cannot be disputed, not all elements of ESG are currently given equal weight by organizations. Although this is to be expected, as not every ESG risk is equally relevant to every organization, the disparity in knowledge and understanding among the separate ESG-related topics is stark. Indeed, The IIA's *OnRisk 2022: A Guide to Understanding, Aligning, and Optimizing Risk* paints a complex view of ESG risk understanding.

Exhibit 1: CAE Knowledge of ESG



Note: *OnRisk 2022* survey question: How knowledgeable are you about each of the following risks? Percentage who gave a rating of 6 or 7 on a scale of 1 to 7. *n* = 30.

Exhibit 2: Risk Relevance



Note: *OnRisk 2022* survey question: How relevant are the following risks in your current organization? Percentage who gave a rating of 6 or 7 on a scale of 1 to 7. *n* = 90 (evenly divided between C-suite, Board, and CAE)

For example, 73% of CAEs rated their personal knowledge of organizational governance as a 6 or 7 on a 7-point scale, with 1 being the lowest rating (not at all knowledgeable) and 7 being the highest (extremely knowledgeable). This contrasts significantly with their reported personal knowledge ratings on social sustainability and environmental sustainability, which are both at 23% (Exhibit 1). The report notes there may be several possible explanations, such as the immediate challenges and focus the COVID-19 pandemic created for organizational governance. Internal audit has extensive knowledge and experience in this area, but in other ESG-related areas, internal auditors may recognize that their technical nature may be beyond their grasp — at least in the short term. Additionally, some internal auditors may have difficulty understanding which ESG risks are most relevant to their organization in the first place, which can complicate early efforts on ESG risk evaluation. This issue is addressed in more detail in the section on risk and materiality assessment.

Despite growing investor pressure for organizations to implement more robust ESG-focused measures such as expanded ESG reporting, the risk relevance of social sustainability and environmental sustainability — two of the three categories under the ESG umbrella — ranked in the report's bottom quartile. When asked about risk relevance to their organizations, 63% of CAEs rated social sustainability as a 6 or 7, and only 50% did the same for environmental sustainability. Expanding the conversation beyond the internal audit function, the picture grows even more disturbing. For C-suite respondents, 60% rated the relevance of social sustainability risks a 6 or 7, and 40% did so for environmental sustainability (Exhibit 2). All of this points to an overall unease with at least certain elements of ESG when measured against risks that are both relevant to the internal audit function's organization *and* within its grasp to understand and act on. As one C-suite respondent said, "Most organizations want to have good environmental sustainability policies, procedures, and programs, but it is not always front and center when dealing with all these other risks[32]."

Expanding the ESG conversation

While leaders are maturing their knowledge and management of ESG, conditions in the global market demand advancement in integrated ESG risk management approaches. According to the World Economic Forum's (WEF's) *Global Risks Report 2022*, environmental and social risks comprised eight of the top 10 most severe risks over the next 10 years, with climate action failure, extreme weather, and biodiversity loss taking the top three spots. Additionally, the WEF report indicates that several ESG-related risks have worsened significantly since the beginning of the COVID-19 pandemic, specifically social cohesion erosion, livelihood crises, climate action failure, mental health deterioration, and extreme weather — all of which rank significantly higher than the next listed risk, which is debt crises[33].

For risk management functions, the challenge in the coming years will not necessarily be to promote organizational ESG education and awareness in their strategic plans — though that should remain an ongoing priority — but to monitor the dynamic and changing ESG risks for an organization. Over time, risk functions should, through their organizational responsibilities, be converting long-term concerns to short-term actions by integrating ESG into ERM and conducting internal audits.

Know industry relevance

To begin the journey from awareness to action, it can be useful to narrow the scope of ESG relevance from a broad, general view to a focused, industry-specific one. Some ESG risks, such as those related to governance, are widely applicable, but environmental and social are usually relevant based on industry and an individual business' context.

"As an enterprise risk management practitioner for our practice, I have seen where ESG risks broadly speaking now constitute top 10 risks for many organizations across the business sector — in many cases top two, as the EY 2022 CEO Outlook Survey indicates," says Uwasomba[34]. "This prominence is driven by many variables. One is investor-related concerns as investor and analyst communities begin to factor ESG-related considerations into their decisions on value. Another is consideration of the rigor and level of regulatory disclosure requirements around ESG risks."

The latter is apparent in the push for SEC guidance related to climate disclosures in the U.S., for example. Outside the U.S., there is an even greater regulatory push from the EU. This is evidenced by the Corporate Sustainability Reporting Directive (CSRD), which includes new requirements around materiality assessments, reporting requirements, and assurance under the umbrella of sustainability-related risks and risk factors (for holistic ESG beyond climate). Beyond the investor and regulatory-related perspective, companies are making some big bets related to corporate strategy and value proposition as they seek to balance the opportunities and threats in their sector, as ESG is impacting industry sectors very differently. Energy, for example, is one industry where many ESG links can be easily drawn in some respects but may be less obvious in others.

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[32] *OnRisk 2022, A Guide to Understanding, Aligning, and Optimizing Risk*, The IIA, 2022, http://theiia.mkt5790.com/OnRisk2022/?webSyncID=a36abe78-0176-13d4-2e22-e271c4e47a0b&sessionGUID=3d51a40c-22aa-c2ba-c0ae-06d82424d6a4.

[33] *Global Risks Report 2022*, The World Economic Forum, January 11, 2022, https://www.weforum.org/reports/global-risks-report-2022.

[34] *Will Bold Strategies Fuel Market Leading Growth? EY 2022 CEO Outlook Survey,* EY, January. 10, 2020, https://www.ey.com/en_gl/ceo/will-bold-strategies-fuel-market-leading-growth.

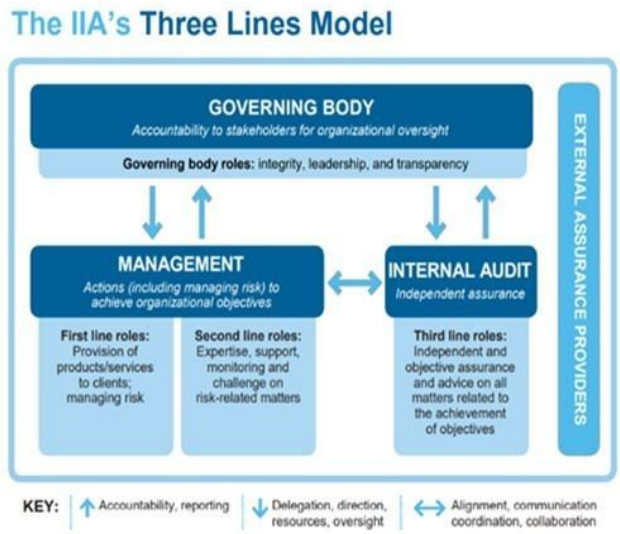
“In the energy sector, we are seeing the physical impact of climate change on infrastructure,” says Uwasomba. “For example, in the power and utilities space, we are seeing an emphasis on enterprise resiliency — particularly in terms of service reliability, asset integrity, and maintenance. Infrastructure and operations teams now look to analyze scenarios and plan how existing assets can be re-tuned to withstand higher levels of impacts — and in some cases, more frequent occasions of disruption — than previously seen. Similarly, in the oil and gas sector, we are all well aware of the environmental impacts, including the strong commitment of major players to reduce emissions and decarbonize. However, we are also seeing strategic and operational considerations that go beyond climate-related risks, to include the social value proposition of the industry. This includes perception of the sector from employees and the community. The ability to attract talent and compete for scarce human resources — or the ability to attract investment to drive opportunities and innovation — is directly tied to social perception, which is inherently ESG related.”

The impact of social perceptions of ESG can be seen in other industries, as well. Even in consumer sectors, says Uwasomba, one can find numerous examples of ESG being a long-term driver of value and perception. “People are now becoming more conscious of the choices they make,” she says. “We now have entire fashion lines and brands founded on these issues. ESG topics have a tendency to focus on the downside, but there is also tremendous upside where the organizational risk is not necessarily what the organization will lose, but rather what the organization could be poised to gain. This is playing out in new products and choices for consumers, some of which are translating to revenue or reduced costs.”

“Companies need to manage and report on the ESG of their operations, value chain, and products as part of their corporate strategy,” says Roberts. “First, they must develop ESG strategy, governance, and reporting that supports stakeholders in understanding how they are delivering long-term value. It’s important to understand who are your stakeholders and are you able to answer their tough questions related to ESG? Organizations also need to understand whether their products and services are strategically positioned in this ESG revolution, which is being heavily driven by changes in the accelerated energy transition and the need for companies to improve their social impacts, such as diversity and inclusion and health and safety. Does your company have a place to play in this ESG future? For example, healthcare is highly focused on evolving its products and services to be focused on health equity and access to healthcare. Another example is how automotive and manufacturing companies are considering whether their products will fit in a low carbon economy.”

The financial sector presents a good case study where all of these elements coalesce. “We see an incredible increase in the financial sector measuring and reporting on the ESG outcomes of their investments,” says Roberts. “They are increasingly concerned that they are financing environmentally and socially responsible companies and products. For example, many banks are starting to measure environmental impacts, such as how investments are contributing positively or negatively to greenhouse gas emissions. They are also considering the social impacts and how investments are driving equity.”

Shared ESG risk responsibilities across the value chain



ESG risk evaluation responsibilities do not fall to a single organizational function. Indeed, regardless of organizational size and structure, this is very much a shared responsibility that necessitates transparency, communication, and alignment across all organizational lines, from onsite operations in the first line, to second line functions such as compliance, to independent, objective assurance providers in the third line. These values remain consistent regardless of risk, in fact, and are the foundation of The IIA's Three Lines Model.

Additionally, internal audit can operate in an advisory capacity from within its third line role. "Internal audit is not just the after-the-fact assurance provider," says Uwasomba. "Our view is that internal auditors should have a seat at the table even when they are trying to understand what material ESG risks their organizations face. Even if the internal audit function is not necessarily best suited to assess a particular ESG-related risk within the organization, which may require skillsets found on the first or second line, it can provide some clarity as to perhaps risk rating criteria and considerations. Internal audit functions also have a broad purview of operations that other functions do not, which can be a key asset in ESG evaluation on an individual organization level. On a basic level, investors are looking for trust, and internal audit consultation plays a huge role in establishing that."

Roberts agrees. "What is keeping leadership teams up at night is their communication approaches to ESG and not meeting the mark in terms of regulatory needs. There's so much information flying out the door in terms of ESG communication and strategy, it can be difficult to establish a strategic approach and consistent market narrative with focused KPIs. Voluntary sustainability disclosures have been common for years, for example, but all of a sudden, investors are making concerted efforts to hold organizations accountable for what they disclose. Even if internal audit does not necessarily have the capabilities to assess ESG reporting accuracy on its own, it does have the capabilities to monitor the robust processes and controls needed to ensure reporting reflects reality. There is no one better than internal audit to be a strategic advisor in supporting its organization to enhance the governance, processes, and controls needed to advance ESG," she says.

ESG Risk Evaluation

Tools at internal audit's disposal

The materiality assessment

There are a variety of approaches and tools at internal audit's disposal to provide significant value-add to organizations seeking to better understand ESG risk. For example, one common tool used by sustainability professionals to identify material ESG topics of focus is called a materiality assessment.

"Materiality assessments are a standard approach to prioritize ESG topics as part of an organization's strategy, reporting, and risk management," says Roberts. "These are used to qualitatively and quantitatively measure ESG topics of relevance based on their importance to your business and stakeholders, which ultimately supports the organization in identifying what elements of ESG should be used in its strategy, goals, and risk management approaches."

Despite some inherent similarities, the process of conducting materiality assessments contains some key differences from conducting traditional risk assessments. For example, by its nature, a materiality assessment contains a much broader context that goes beyond organizational impact from risk. The most widely accepted model for ESG materiality assessments comes from the World Business Council for Sustainable Development (WBCSD), which divides the process into seven steps:

- Define the purpose of the materiality assessment.
- Determine the ideal materiality cycle.
- Establish the organization's perspective on materiality (the business case perspective and/or the societal impact perspective).
- Identify the topics.
- Determine stakeholders' involvement in the assessment.
- Establish criteria for calculating materiality scores.
- Based on materiality scores, select the material topics to include in the final assessment.[35]

Materiality assessment may also be used to support embedding ESG risk within an organization's risk management processes in enterprise risk management (ERM) and internal audit. Integrating ESG into ERM may be informed by the COSO and WBCSD guidance, *Enterprise Risk Management: Applying Enterprise Risk Management to Environmental, Social, and Governance-related Risks.*[36]

"There are only a small number of mature companies that have integrated ESG into ERM, which we expect to advance in the short-term as ESG risks must be integrated and aligned with other company risks," says Roberts. "Material ESG topics should also be used to identify the internal audit plan."

Double materiality assessments

[35]. *The Reality of Materiality: Insights From Real-world Applications of ESG Materiality Assessments*, World Business Council for Sustainable Development, June 20, 2021, https://www.wbcsd.org/Programs/Redefining-Value/Redesigning-capital-market-engagement/Resources/The-reality-of-materiality-insights-from-real-world-applications-of-ESG-materiality-assessments.

[36]. *Enterprise Risk Management: Applying Enterprise Risk Management to Environmental, Social, and Governance-related Risks*, COSO and World Business Council for Sustainable Development, October 2018, https://www.coso.org/Documents/COSO-WBCSD-ESGERM-Guidance-Full.pdf.

It is also worth noting that materiality assessments are evolving. Although details are not finalized, the EU has announced requirements for applicable organizations to soon conduct "double materiality" assessments. In the case of ESG, equally important to risk impact on organizations for investors (and for presumably complying with future regulatory standards) is the organization's impact, environmentally and socially, within the society it operates. A double materiality assessment gives equal weight to both sides — even if such information does not necessarily reflect positively on the organization. For example, a company must report the impact of risk it faces due to climate related issues along with the impact the organization has on the environment with its greenhouse gas emissions, which may show significant room for improvement. The organization is an entity responding to the changing risk landscape, but it is also a risk unto itself. Without assessing both, organizations may not be analyzing the full picture of financial and reputational consequences.

"Companies are just now starting to explore conducting double materiality assessments, which will support a high level of sophistication regarding ESG risk evaluation," says Roberts. "However, the use of the double materiality approach is expected to change as the EU requirements come into effect," says Uwasomba. The concept of risks, interrelated risk drivers, and their relationship are areas that internal audit and other risk functions understand and can help their organizations with as they navigate this type of assessment. Internal audit functions are encouraged to include these in their audit plan where applicable in order to begin understanding more about this area, particularly if the organization has operations in the EU, she added.

Benchmarking

For internal auditors looking to guide their organizations in taking the next step toward such maturity, it can be beneficial to look at the advancements made by others. "In an environment where some organizations may be more mature than others, internal audit is brilliantly positioned in their space to provide an organizational benchmarking by way of some kind of maturity assessment," says Uwasomba. "They are in a position to ask and answer pertinent questions such as 'How are others in my sector or outside of my sector doing this, and how does my company compare?' To provide that kind of insight to the company on where the gaps exist related to ESG programs is invaluable."

One of the clearest resources internal auditors can use in the benchmarking process is company disclosures, which companies have been under increased pressure from investors and other stakeholders to provide. Particular focus has been placed on climate risk disclosures, but other ESG topics such as diversity and human rights have received attention, as well. Although there are frameworks in existence that can provide a foundation for quality ESG reporting such as the Greenhouse Gas Protocol and the Task Force on Climate-Related Financial Disclosures (TCFD), with global reporting standards yet to be formally announced, evaluating the quality of a peer company's disclosures against one's own — and providing assurance that adjustments are made accordingly — can be a valuable deterrent against associated reporting risks such as unintended (or intended) greenwashing. This type of analysis also can be included in internal audit plans.

Climate risk and other ESG risk assessments

After establishing which risks are most relevant to the organization and assessing the frameworks currently in place, the next step in maturing an organization's ESG risk assessment strategy is the implementation of specific risk assessments. These include climate risk assessments, but also additional assessments associated with social and governance risks. While some of these risk assessments require a high level of technical analysis and are still maturing in industry (e.g., a TCFD climate scenario analysis to inform climate risks and opportunities will likely require external expertise to conduct), engaging internal audit as part of the process can be invaluable to helping the organization understand whether they have been completed; internal audit can also support which ones to prioritize by industry, stakeholder demands, and available resources.

"Climate risk assessments and other such assessments can be looked at as almost a subset of one of the broader ESG risk areas that may be the outcome of the company's materiality assessment," says Uwasomba. "In the case of climate risk assessments, for example, this assessment is an opportunity to really focus in to gain a deeper understanding of the organization's risk exposure to climate change. This might not be what the organization should prioritize first, but once you understand what is material to the company, as part of early ESG strategy development, completing a climate risk assessment should be the next goal."

The IIA has found the latter variable of particular consideration due to the current reality of the risk landscape. Following the COVID-19 pandemic, for example, a significant number of internal audit functions experienced budget cuts. According to the *2022 North American Pulse of Internal Audit*, 18% of all internal audit functions surveyed reported budget decreases in 2021 from the previous year — a year that saw the highest percentage of reported budget cuts among internal audit functions in the history of the survey (36%).[37] While this is an improvement to near pre-pandemic levels, the same cannot be said for internal audit functions reporting budget increases. According to the data, 2020 and 2021 saw the lowest percentages of survey respondents reporting internal audit budget increases since 2008 (20% in 2020 and 24% in 2021, respectively). "Sluggish growth in internal audit budgets may reflect general uncertainty or cautiousness among organizations as the world slowly emerges from two years of COVID-19 disruption, as well as a reluctance to return to pre-pandemic travel," the report states. Should such sluggishness continue, internal audit functions in some instances may be prompted to prioritize certain short-term ESG topics (organizational governance) over others that necessitate a more long-term view (social sustainability).

Roberts adds that while that while completing such assessments should be the goal, in order to follow the industry standards identified in frameworks such as the TCFD scenario analysis, an extremely high level of technical knowledge is necessary. A climate risk assessment, for example, entails incorporating diverse data sets that require diligent monitoring and assurance for transparency, accuracy, and consistency. In most cases, this will be beyond the knowledge base of the internal audit function. Internal audit should not be focusing on completing such assessments themselves, but participating in the process as an advisor through collaboration with external functions that specialize in the field. These assessments benefit from assessing climate risk aligned with the organization's broader approach to risk evaluation (e.g., aligning use of impact and likelihood).

This does not mean that internal audit should not strive to expand its knowledge base of ESG, however. Quite the contrary, in fact. "CAEs and their functions need to get educated themselves," says Uwasomba. "This is an exciting area and an opportunity for internal audit teams to learn more about a risk that is having a real transformational impact on their organizations. For the internal function that seeks to be an advisor preparing its organization for these risks and opportunities, they need to be building an understanding themselves."

[37]. *2022 North American Pulse of Internal Audit*, The IIA, March 2022, https://www.theiia.org/en/resources/research-and-reports/pulse.

Conclusion

An ever-evolving risk

ESG risks in themselves run the gamut — with some risk areas gaining more prominence in recent times. And as is the nature of risk, a few continue to evolve and mature even as internal auditors' understanding of the topics under ESG evolve and mature. In many ways, 2022 represents a current apex in this topic, and never before has so much onus fallen to organizations to be active, willing, and genuine participants in the ESG discussion. Even so, as ESG awareness heightens globally, and governments, organizations, and organizational stakeholders down to the individual consumer become more invested in the ESG conversation, organizations must be prepared to respond to their concerns and demands.

Much like flying an airplane without navigational equipment or hiking in the woods without a compass, fulfilling the demand for more action regarding ESG evaluation while waiting on formal regulatory guidance can prove difficult — as well as costly — if mishandled. However, even in this risk environment, internal audit has tools at its disposal to provide substantial organizational value — through objective assurance of ESG controls, through advisory services on ESG risk evaluation, and even through simple promotion of ESG risk awareness and education. In many ways, it is through internal audit that quality communication, transparency, and alignment among the three lines and stakeholders run. This is an invaluable position to be in, and one that should be actively encouraged and pursued by today's CAEs.

About The IIA

The Institute of Internal Auditors (IIA) is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today serves more than 210,000 members from more than 170 countries and territories. The association's global headquarters is in Lake Mary, Fla., USA. For more information, visit theiia.org.

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