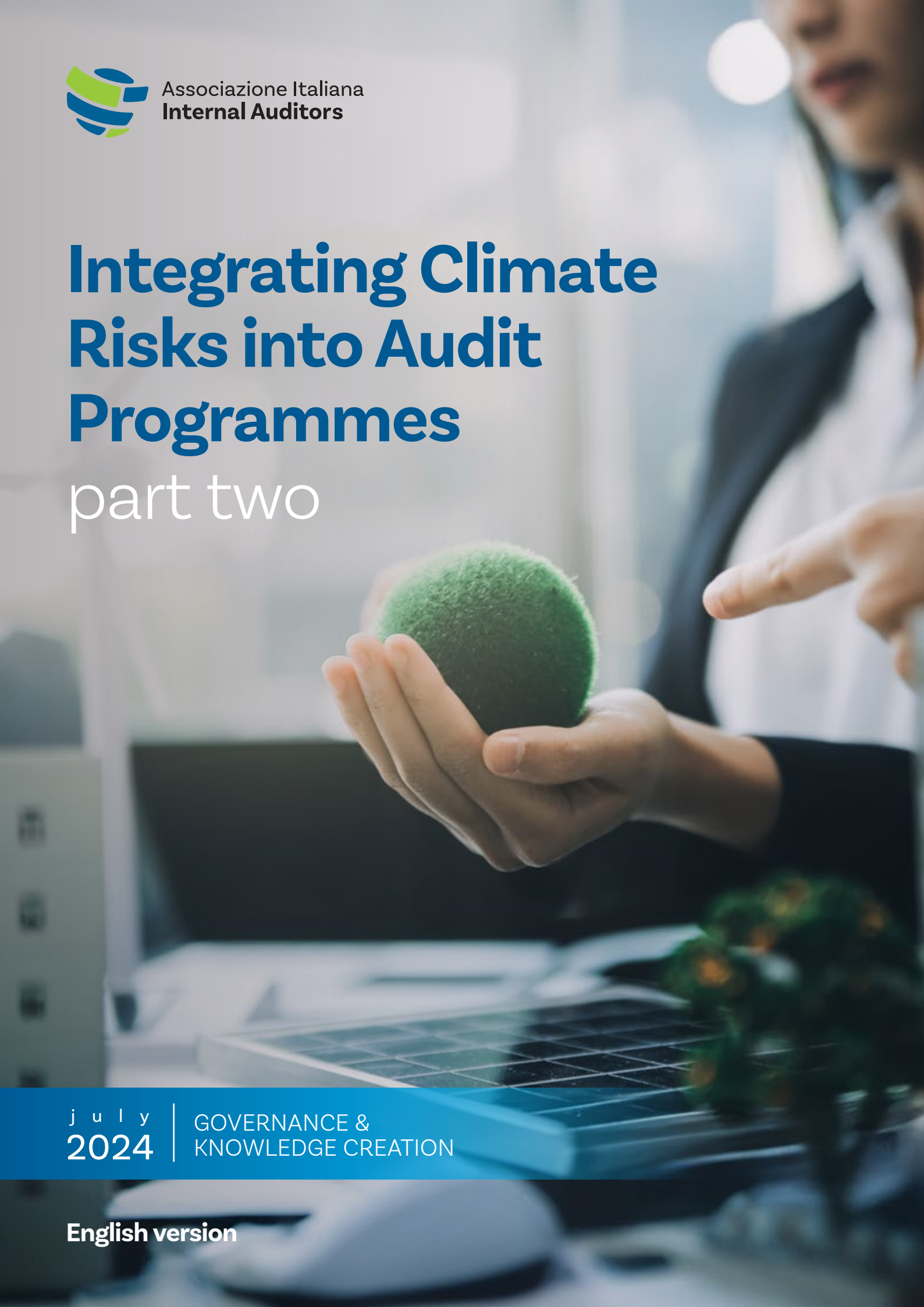
Associazione Italiana
Internal Auditors

Integrating Climate Risks into Audit Programmes

part two



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GOVERNANCE &
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English version

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1. Introduction

Internal auditing enhances an organisation's ability to serve the public interest.

This is set out in the Global Internal Audit[1] Standards , which present the Purpose of Internal Auditing.

The Purpose Statement explains that:

Internal auditing strengthens the organization's ability to create, protect, and sustain value by providing the board and management with independent, risk-based, and objective assurance, advice, insight, and foresight.

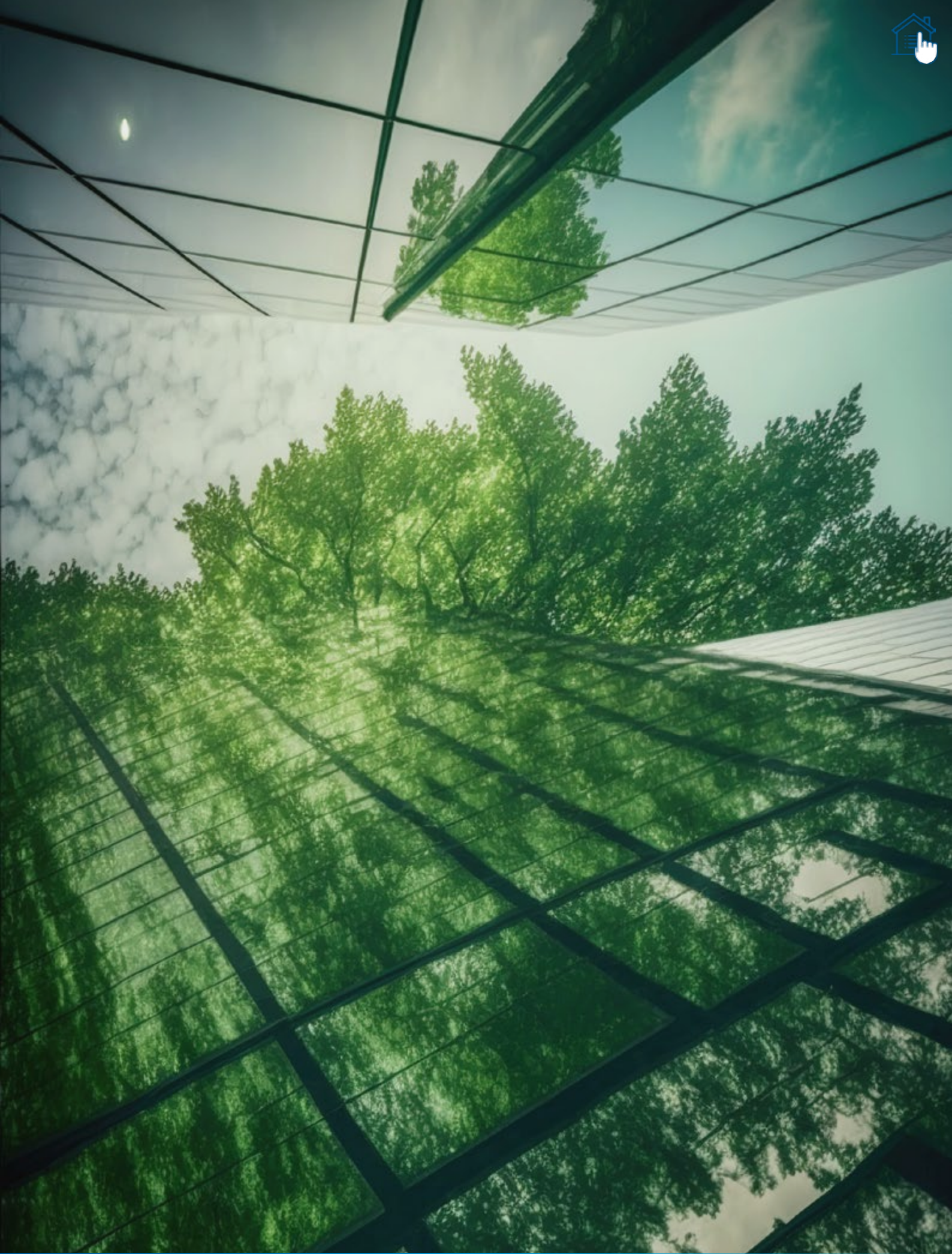
Internal auditing enhances the organization's:

- *Successful achievement of its objectives.*
- *Governance, risk management, and control processes.*
- *Decision-making and oversight.*
- *Reputation and credibility with its stakeholders.*
- *Ability to serve the public interest.*

This purpose statement is fully in line with the spirit that, since its inception, has animated this AIIA Working Group (hereinafter referred to as WG), dedicated to climate risks, an issue that is at the centre of the international debate on the relationship between businesses and the public interest.

Produced to coincide with the release of the new standards, Part Two of the paper 'Integrating Climate Risks into Audit Programmes' takes the WG's study further in the direction of providing increasingly operational information and tools for integrating climate change risks into internal auditing..

1 The Global Internal Audit Standards were published by the Institute of Internal Auditors (IIA) on 9 January 2024, replacing the previous 2017 version. They will officially come into force in January 2025, but the Institute encourages early adoption as they are aligned with best practice.



2. Aim and scope

As explained in Part One of the paper[2], the purpose of the project is essentially practical and consists of providing suggestions on risks and controls that can be considered when designing audit programmes that include climate change issues. Part Two analyses the following five processes:

1. New Product Development;
2. Production;
3. Logistics; ;
4. Sales and Marketing;
5. Finance.

The risk map used as a reference is the same as that used for Part One of the document, to which reference is made[3] .

2 'Integrating Climate Risks into Audit Programmes - Part One', published by AAIIA in November 2023.
3 Chapter '4. Risks', page 11.

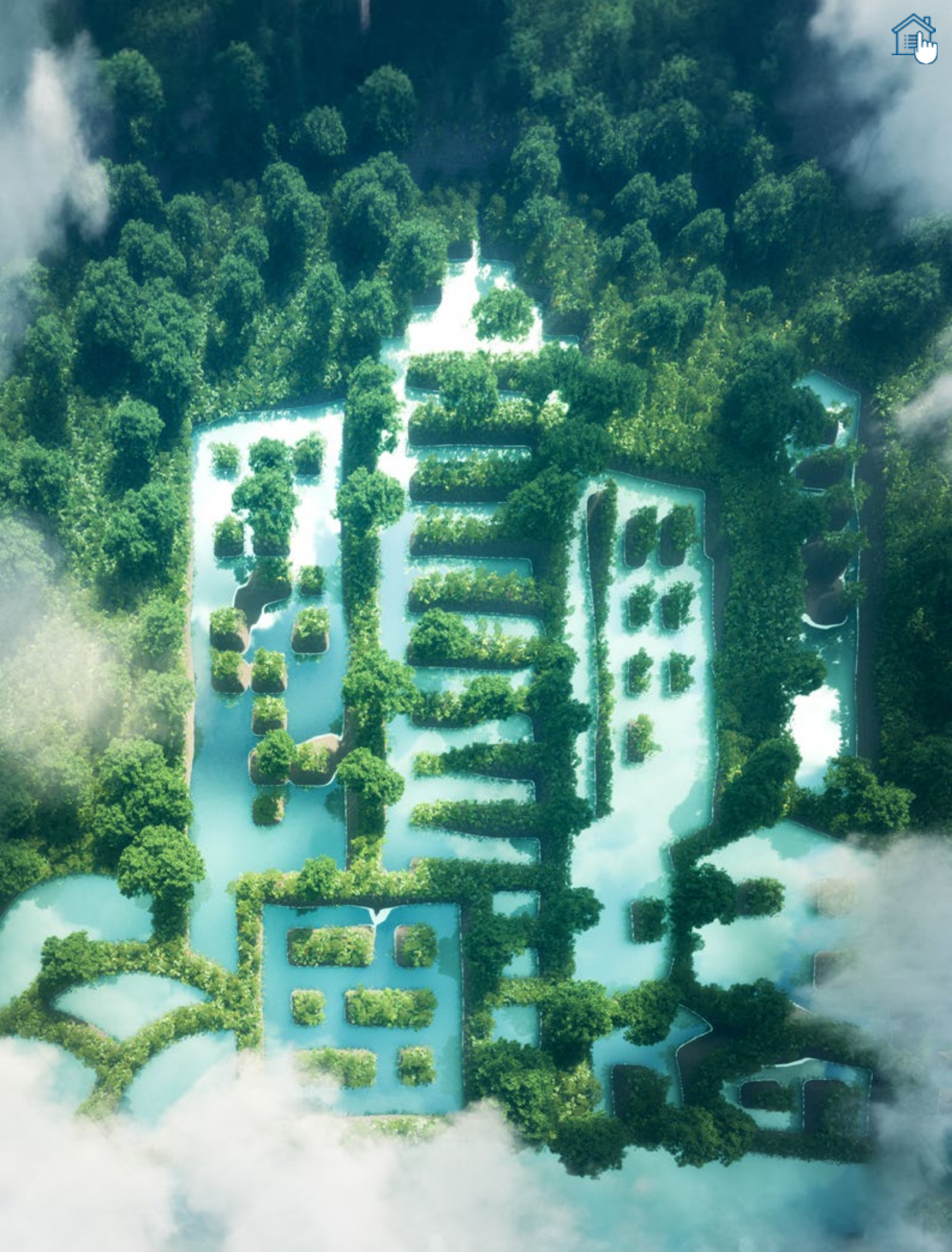
3. Methodology

As with Part One, the proposed ideas are the result of collaborative creative work, as the WG has consolidated and integrated the proposals developed in dedicated brainstorming sessions with internal auditing experts. In particular, over 30 professionals from different business sectors, organised into working tables[4], were invited to select a process for each group, identify the main climate change risks and, above all, propose the controls that would best help mitigate these risks.

Once again, the creative activity was aided by the opportunity to ask live questions to Chat GPT, which provided confirmation or complementary answers on the applicable controls for the processes/risks under investigation.

Each group then presented its main findings in a plenary session. Video clips were extracted from the presentations and will be published as an integral part of this paper.

4 The activity took place on 20 February 2024, at the 'Protiviti Lab' creative space in Milan.



4. Controls

The key controls associated with the most relevant climate change risks for the processes listed in the introduction (New Product Development, Production, Logistics, Sales and Marketing, Finance) are presented below.
For Finance processes, an additional version has also been developed for the financial sector.

4.1 New Product Development

Given the magnitude of climate risks and the timeline of impacts, the following steps in the new product development process can be considered critical:

- the **design** of the new product, which must be functional and saleable in the long term from the initial stages, incorporating 'eco-sustainable' design principles to mitigate the environmental impact of the product throughout its life cycle;
- the **value chain**, i.e. all aspects not directly related to the product itself, but to the pre- and post-production stages, which must include the adoption of sustainable practices

In summary, the ability to develop a product that is attractive to the market and saleable (in the long term) should be considered, also taking into account the raw materials that need to be sourced and the distribution methods. The process of 'sustainable' product development involves the adoption of policies and practices that consider not only the economic impact of the product throughout the value chain, but also the environmental - and social - impact of the product itself in the long term, using a systemic approach.

The table below provides a list of the climate change risks examined and a selection of research and development process controls that companies can implement to respond to these risks.

Rischi Climate Change	
Risks	**Controls**
Physical risks - Active (Emissions/Consumption/ Land use))	**Stakeholder involvement:** involving stakeholders, including communities, customers and experts, helps to identify climate-related risks and opportunities early in the product development process. This input can inform the decision-making process and drive innovation. **Clean by design and LCA - Life Cycle Assessment:** conducting life cycle assessments helps identify the environmental impacts at each stage of the product life cycle, from raw material extraction to disposal, so that all aspects can be considered at the design stage to minimise the impact of production and environmental risks that may affect production (e.g. increased raw material prices). **Monitoring:** collecting and analysing data on energy production and consumption, water use, etc., which can be broken down into relevant metrics to assess the effectiveness of initiatives and establish a useful metering system over time. **Scenario analysis:** conducting scenario analyses helps to assess the potential impact of climate-related risks on products and business operations. This enables the development of proactive risk management and adaptation strategies. **Risk Assessment and Planning:** linked to the scenario analysis in the previous point, it is also appropriate to check the product (e.g. in terms of the raw materials used) against the possible long-term scenarios (and related targets). **Continuous improvement:** implementing a continuous improvement process ensures that products evolve over time to address climate change and stakeholder needs. This involves monitoring performance, seeking feedback and adjusting design and strategies. **Training and information:** raising employee awareness, developing a sustainable culture and encouraging participation in mitigating the overall environmental impact, facilitating dialogue between different departments so that everyone is aware of the impact on upstream and downstream work phases.
Physical risks - Passive (Acute phenomena)	**Resilience planning:** it is essential to design products that are resilient to climate-related hazards such as extreme weather events, sea level rise and resource scarcity. This could include building adaptive functionality, redundancy and flexibility into the design and infrastructure of the product. **Business continuity plans:** defining the measures to be taken to ensure that the organisation can continue to operate in the event of unforeseen events, minimising disruption and resuming operations in the shortest possible time (e.g. continuous monitoring of weather conditions to anticipate and mitigate potential impacts, vulnerability assessment of key facilities and implementation of protective measures, planning of preventive maintenance to ensure the robustness of the infrastructure, insurance of critical infrastructure against weather damage, regular data backups and implementation of disaster recovery systems, use of resilient infrastructure and R&D-specific business continuity plans). **Sustainable sourcing:** this term refers to a set of actions ranging from using materials and resources from sustainable sources/recycled materials (circular economy) to sourcing from suppliers with environmentally responsible practices and promoting transparency in the supply chain. This can also be achieved through partnerships with suppliers or by identifying alternative suppliers in case of unavailability. Additionally, analysing the product's bill of materials (not only from a financial point of view but also with regard to the sustainability of materials and processes) and monitoring raw material costs are elements that complete the integrated approach to sustainable procurement *(for a more detailed discussion, please refer to Part One of the paper, published in 2023, which specifically includes the purchasing process).*

Rischi Climate Change	
Risks	**Controls**
Market risks	**Access to capital:** evaluating access to loans/financing according to the 'green' or 'sustainable' label given to the products developed.
Transition risks - Technological and product-related (need for and difficulty of replacing suppliers or raw materials)	**Regulatory compliance:** Ensuring that products comply with existing environmental regulations and standards is crucial. This includes understanding emission limits, waste disposal regulations and sustainability requirements. *N.B. in this regard, it is advisable to adopt 'prudential' requirements, i.e. ones adapted to countries where more stringent rules apply.*
Reputational risk	**Verified communications:** ensuring that communications relating to the sustainability of developed products are verified prior to disclosure. Combining communication with the monitoring of public opinion on products placed on the market, in order to understand their adequacy with respect to expectations and to obtain useful input for the development of new products/variants, with a particular focus on environmental impact.
Reporting risks - Integrity and quality of data/ information	**Target setting and alignment:** identifying management targets aligned with sustainability issues and sustainable product development. **Standards and tools:** implementing data management systems (including for environmental data) to collect and analyse information (centralised databases, reporting applications, possibly environmental management software).

Incorporating these practices into the product development process could not only mitigate the environmental impact of the products designed and marketed, but could also lead to competitive advantages for the company that adopts them, as well as enhancing its reputation and meeting the ever-increasing expectations of consumers regarding the design and sale of 'eco-friendly' products.

4.2 Production

As several scientific studies on the subject have shown, industrial production activities are one of the main sources of greenhouse gas emissions and thus a major cause of global warming.

In the context of climate change, business production processes can:

- on one hand, be a tool on which to intervene in order to define more 'sustainable' production models in terms of environmental impact and the use of renewable energy;
- on the other hand, be threatened by the effects and consequences of climate change, with risks to business continuity, workers' health and safety, etc..

It therefore seems more appropriate than ever to integrate climate change risks into the design, implementation and monitoring of production processes, as well as into the risk assessment of third parties directly or indirectly involved in companies' value chains.

The table below provides a list of the climate change risks examined and a selection of production process controls that companies can implement to respond to these risks.

Rischi Climate Change

Risks	Controls
Physical risks - Active (Emissions, Consumptions)	Measuring and monitoring environmental performance: collecting and analysing data on energy consumption and emission levels of production processes, which can be broken down into a number of relevant metrics to assess the effectiveness of various energy efficiency initiatives in operations and to target the search for lower emission production technologies. Monitoring applicable legislation: the existence of an appropriately structured process for monitoring applicable (national and supranational) legislation on environmental aspects, and the existence of information flows between those carrying out such monitoring and decision-makers within the organisation. Analysis of the current energy mix and alternative sources: analysing the current 'energy strategy' and whether there is a plan for alternative sources.
Physical risks - Passive (Acute phenomena)	Business continuity plans: analysing the measures to be adopted to ensure that the organisation is able to continue operations in the event of unforeseen events (e.g. the occurrence of acute climatic phenomena that could have significant effects on the business continuity of production processes in terms of plants, assets and supporting technological systems), minimising interruptions and restoring operations (disaster recovery) in the shortest possible time. Such plans could also lead to the research and identification of infrastructure resilient to extreme weather conditions. Risk transfer: evaluating 'risk transfer' strategies for acute phenomena, either through possible specific insurance policies or through contractual clauses with third parties involved in the process. Measuring third party risk on the supply chain (direct and indirect): tools and processes for measuring and assessing the risk level of third parties involved along the supply chain, integrated with risk drivers related to possible effects of climate change on the supply chain (e.g. raw material availability). Such tools can also support decision-making processes and sourcing strategies[5] (e.g. in a supplier diversification logic).

5 For details of risks and controls relating to the Purchasing process, see section 5.3 of Part One of the paper, published in 2023.

Rischi Climate Change	
Risks	**Controls**
Transition risks - Regulatory and legal constraints	**Monitoring applicable legislation:** the existence of an appropriately structured process for monitoring applicable (national and supranational) legislation on environmental aspects relating to production processes, and the existence of information flows between those carrying out such monitoring and decision-makers within the organisation. **Participation at round tables:** the process of managing relationships at institutional level for active participation in policy-making processes. **Training and information:** ensuring (periodic) employee training on new regulations, with a particular focus on rules affecting materials and production processes in relation to climate change.
Transition risks - Technological and product-related	**Maintenance and investment plans:** the existence of maintenance plans aimed at avoiding or mitigating technological obsolescence of production and product processes, as well as investment plans for new technical solutions with a lower or minimal environmental impact that can accelerate the transition to a new model and increase the resilience of the organisation.
Transition risks - Market-related	**Capacity plans:** the existence of investment/disinvestment plans as a tool to respond promptly to expected changes in production capacity, as changes in consumption patterns could create risks of under/overcapacity of production and technological processes in relation to new real market needs.
Transition risks - Reputational	**Communication and certification:** promoting transparent communication of 'sustainable initiatives' undertaken by the company at production process level. Adherence to sustainability standards and certifications in relation to production processes in order to reinforce the image of a 'sustainable company' in the eyes of the market and to strengthen the company's image in terms of its impact on climate change.
Reporting risks - Integrity and quality of data/ informationi (Inconsistent data, incorrect calculations, lack of traceability of sources)	**Environmental reporting systems:** implementing management systems for data (including environmental data) to collect and analyse information (centralised databases, reporting applications, possibly environmental management software). In addition, automating environmental reporting processes (to reduce errors and improve efficiency) may include creating pre-defined reports, integrating data from different sources, automating calculations; standardising data and methodologies is a critical success factor for the efficiency of this technology investment. Finally, the security of the company's environmental data should be ensured, as well as the implementation of internal audit processes to ensure the accuracy of the information. **Standards and tools:** adopting recognised environmental reporting standards and ensuring effective compliance with these standards through regular auditing of sustainability statements by qualified experts.

Internal Audit functions can monitor the existence and proper application of the controls listed in the table above to help mitigate climate change risks in production processes. One thing that could be considered is 'environmental audit' plans aimed specifically at reviewing the effectiveness and efficiency of the control framework in place, with particular reference to production facilities and processes.

4.3 Logistics

Logistics, understood as the complex system of handling, storing and distributing goods (raw materials, semi-finished and finished products), is critical to ensuring the operational efficiency, competitiveness and resilience of companies in an ever-changing physical and regulatory climate.

Of all business processes, logistics is proving to be one of the most complex and also one of the most vulnerable to risks related to climate change, as it is heavily influenced by various factors such as weather conditions, extreme events, the availability of natural resources and the environmental impact of logistics operations themselves.

A critical management issue also arises from the extensive use of outsourcing: the control system and the ability to implement improvement actions are conditioned by dependence on third parties, lack of information and visibility, and contractual and legal constraints.

The main sub-processes considered in terms of climate impact are:

- transport, which is particularly vulnerable to weather phenomena and, above all, is at the centre of innovation projects and research and debate groups at local, national and international level to find solutions to limit emissions (including frequent regulatory changes);
- inventory management, which is one of the focal points of logistical optimisation (in terms of choice of storage locations) and has a significant exposure to passive physical risks; in addition, inventory planning for certain goods may be affected by predictable changes, both short and long term.

The table below provides a list of the climate change risks examined and a selection of logistics process controls that companies can implement to respond to these risks.

Rischi Climate Change	
Risks	**Controls**
Physical risks - Passive (Acute phenomena)	**Business continuity plans:** defining measures to be taken to ensure that the organisation is able to continue operations in the event of unforeseen events, minimising disruptions (to both transport and storage); outsourcers should also be included in continuity plans. **Risk transfer (insurance policies):** assessing insurance coverage for losses potentially caused by adverse physical events; the control may be extended to outsourcers, possibly with specific contractual clauses. **Infrastructure resilience analysis:** periodic resilience testing (e.g. simulating emergency situations) and subsequent maintenance of logistics infrastructure to ensure it can withstand climate impacts. Depending on the test results, it may also be necessary to define improvement measures (e.g. drainage channels, drainage pumps and flood barriers, window and door protection systems and structural wind reinforcements).
Physical risks - Active (Emissions and Consumptions)	**Environmental optimisation of transport:** transport optimisation programmes should also include emission reduction targets and be based on comprehensive assessments of the geographical location of production plants, logistics facilities and distribution (and possible disposal) networks; the assessment should also take into account any outsourcers and possibly transport along the upstream supply chain. **Market scouting:** continuous market scouting for alternatives (especially in terms of means of transport). Sustainable sourcing: the search, evaluation, selection and contracting of logistics counterparts must be aligned with climate risk mitigation targets. **Maintenance:** adopting regular maintenance practices (which should also be evaluated in the clauses of contracts with third parties) allows emissions to be contained, particularly with regard to means of transport. **Monitoring:** collecting and analysing data on logistics-related emissions to assess performance trends and the effectiveness of initiatives implemented.
Transition risks - regulatory and legal constraints (compliance costs, fines, penalties, litigation)	**Procedures and policies:** integrating and updating operating manuals, business processes and their governing procedures through continuous monitoring, with clear responsibilities, in relation to local, national and international environmental and climate regulations. **Training and information:** raising employee awareness of environmental and climate change regulations and their impact on logistics operations; ensuring that employees involved are aware of their responsibilities and legal obligations. **Audits:** regular audits to assess compliance with environmental and climate regulations in the areas of transport and storage, defining action plans for any areas of improvement identified. **Stakeholder involvement and participation at technical tables:** actively participating in working groups and committees to keep abreast of and contribute to the development of new climate change regulations and policies, with a focus on logistics flows.

Rischi Climate Change	
Risks	**Controls**
Transition risks - Technological and product-related (need for and difficulty of replacing technology)	**Life Cycle Assessment (LCA):** assessing the impact of products throughout their life cycle, from development to disposal, to provide the basis for logistical optimisation and identification of opportunities for substitution of inappropriate technologies and materials (e.g. assessment of materials used for packaging and protection during transport and storage, which can lead to the selection of those with lower emissions). **Assessment of technological alternatives:** the comparative assessment of available transport and storage technologies allows the identification of potential more sustainable alternatives. **Planning:** starting with an analysis of logistical risks in relation to climate impact, defining a technology transition plan with clear targets, including financial planning of investments and costs, as well as the skills required. **Partnership:** identifying logistics partners with whom to find joint solutions to increase the efficiency and effectiveness of technology substitution programmes, for example through better scouting of alternatives, sharing of investments and risks, access to technology prototypes and technical support.
Reporting risks - Integrity and quality of data/ information (Inconsistent data, incorrect calculations, lack of traceability of sources)	**Standards and tools:** identifying a common calculation methodology (shared internally and/or with suppliers) ensures that data (e.g. regarding emissions) are reliable and come from as homogeneous and consistent sources as possible; at the same time, identify appropriate channels and tools for data collection and validation (e.g. IT tools) (possibly in agreement with suppliers) to ensure a timely and controlled flow; finally, data management procedures that include automatic checks and/or manual controls. **Monitoring:** second- and/or third-party auditing (including any external audits) on the reliability of the reported data affecting the company's non-financial disclosures in relation to logistics operations, to reduce the likelihood of undocumented, incomplete or incorrect information.

As far as **logistics** processes are concerned, it is important to emphasise how they are particularly influenced by the company's make-or-buy decisions and purchasing strategies (for more on this, please refer to the **procurement** controls discussed in the first part of this paper)[6].

6 ibid., page 18, section '5.3. Purchasing Processes'.

4.4 Sales and Marketing

Like the previous processes - Product Development, Production, Logistics - the Sales & Marketing process is exposed to the risks of climate change. The Sales & Marketing process varies from industry to industry, depending on the focus of the process (product or service) and the counterparts (B2B, B2C, etc.), but has certain steps in common at a high level:

- market/target analysis and promotion strategies;
- pricing definition;
- active promotion through the channels and communication campaigns deemed appropriate;
- actual sales.

The table below provides a list of the climate change risks examined and a selection of business process controls that companies can implement to respond to these risks.

Rischi Climate Change	
Risks	**Controls**
Physical risks - Passive (Acute and/or Chronic)	**Scenario analysis:** using these tools to define price and margin makes it possible to 'stress' certain cost items (both internal and external) in order to identify pricing strategies and elasticities to guarantee the expected margin. **Contractual clauses:** for external cost elements such as raw materials and semi-finished goods, rather than external processing, which may be affected by climate risks and have a significant impact on costs, review the actual process of defining protective contractual clauses through concepts such as price caps, flexibility and/or counterpart obligations, etc. **Auditing the availability of production factors (internal and external):** to be carried out continuously and linked to the auditing of resilience to physical climatic phenomena carried out by the relevant functions in upstream and downstream business processes, in order to understand the relevance of any critical issues or bottlenecks (to be mitigated by redundancies or diversifications); the audits should also be extended to the main suppliers or outsourcers (also as a way of diversifying sources of supply).
Transition risks - Market-related	**Training, skills and information:** rapid changes regarding the market and external (e.g. regulatory) constraints require companies to continue upskilling if not reskilling their resources (marketing, sales and front-end) in order to generate the expected awareness of and focus on issues relating to ESG and more specifically climate change, and subsequently the necessary skills. This requires appropriate training and information programmes. **Analysis and information tools:** a focus on and awareness of the issues to be addressed is a fundamental basis, but may not be sufficient to tackle the market. It is therefore desirable for organisations to equip themselves with tools and external sources of information that can provide indications of the evolution of the phenomenon and how it is perceived by their target market. **Integrated product supply chain and product positioning:** effective and efficient coordination between the functions responsible for the various processes involved in launching and managing a new product/service (Development, Production, Sales & Marketing, Logistics) to ensure that an integrated and supply chain vision reduces the risk of incorrect product positioning, which could prove very costly.

Rischi Climate Change

Risks	Controls
Transition risks - Regulatory and legal	**Regulatory monitoring:** within the scope of its responsibilities, regulatory monitoring must be continuous and focused not only on compliance with existing regulations, but also on the foreseeable development of those regulations and regulations with foreseeable effects in the coming years. Such monitoring may be managed and coordinated by central structures within an organisation, but it will be difficult to ignore specific monitoring for the functions in the Sales & Marketing process. **Integrated product supply chain:** again, an integrated supply chain view of regulatory impact - from product/service development to sales - reduces the risk of errors which, if not caught early, could prove very costly.
Transition risks - Reputational	**Communication strategies:** given the sensitivity of the issues, it is necessary to define a clear communication strategy that explicitly addresses the question of how to deal with the issue of climate change, in order to find the right message to put across and the most appropriate tools to do so (at both individual product and company level). **Verified communication:** nothing can be more destructive than incoherent or misaligned messages to stakeholders, so having a process in place to verify and approve communications to the media and via social networks is important. **Certifications:** identify possible certifications of interest to the business target, assess their costs and benefits and communicate their achievement in a transparent manner. **Auditing business partners and outsourcers:** the reputational risk associated with the distributor or partner offering goods or services to the market (e.g. franchise or agency) can be mitigated by auditing the policies and credibility of partners, including in the Sales and Marketing area, through careful selection of counterparts, the definition of specific contractual clauses, training and periodic audits. **Consumer/reference market education programmes:** information or education campaigns can be launched for the target market, not necessarily related to a specific product, but deliberately informative/educational and linked more to a medium-term positioning of the company on the climate change issue, so that it can be recognised as an active and attentive actor and thus enable subsequent more targeted marketing/communication activities.
Reporting risks - Greenwashing	**Data monitoring and verification:** implementing accurate monitoring systems to collect environmental impact data for marketing initiatives. Participating in programmes and initiatives certified by market-recognised third parties.

4.5 Finance

The process refers to activities related to the management and optimisation of the company's financial resources:

- financial planning;
- plan execution (i.e. cash management, fundraising, investment management and corporate finance);
- reporting.

Climate change can affect a company's financial processes in a number of ways, generating Passive Physical Risks - such as supply chain disruptions due to extreme weather events resulting in financial losses, Transition Risks - such as increasingly stringent environmental regulations that can lead to additional costs for non-compliant companies, as well as potential fines or penalties, and Reporting Risks - such as climate change financial statements that are not properly audited, resulting in an impact on the company's image.

The table below provides a list of the climate change risks examined and a selection of financial process controls that companies can implement to respond to these risks.

Rischi Climate Change	
Risks	**Controls**
Physical risks - Passive (Acute and/or Chronic)	**Diversification:** implementing an effective strategy to diversify investments and financial activities to reduce exposure to sectors vulnerable to climate change. **Risk assessment and monitoring:** the existence of a process for assessing and monitoring risks related to extreme weather events that could affect the supply chain (supplier selection) and the availability of financial resources (financial partner selection), preferably as part of the company's Enterprise Risk Management (ERM) process. **Introduction of 'green' KPIs:** identifying qualitatively robust climate change related indicators to be monitored over time to avoid increasing the cost of access to finance; also identifying clear governance in the management of these KPIs as well as possible improvement plans to meet targets. **Insurance:** adopting climate risk insurance plans/policies for financial assets and key infrastructure. **Financial business continuity plans:** developing financial planning to deal with potential disruptions related to adverse weather events. **Credit analysis:** assessing potential climate impacts on borrowers' assets.
Transition risks - Regulatory and legal constraints / Market-related / Reputational	**Governance and internal regulatory framework:** in order to mitigate reputational and greenwashing risks - linked to the possibility of raising capital and/or investing from de facto non-green sources and/or in de facto non-green assets - it is essential to implement a **structured governance** framework that emphasises the management and integration of climate risks into decision-making processes, as well as ensuring the existence of **policies and procedures** aimed at mitigating the effects of climate risks and measuring their financial impact. **Monitoring external legislation:** ensuring constant monitoring of sustainability and climate change regulations in order to adapt the company's financial strategy to emerging legal and regulatory constraints. **Training and information:** developing, implementing and monitoring sustainability and climate change training programmes for Finance employees.

Rischi Climate Change	
Risks	**Controls**
Reporting risks - Inadequate disclosure / Greenwashing	**Integrated financial reporting systems:** implementing financial reporting systems that include climate change risks and opportunities, with a focus on implementing internal control processes to ensure the accuracy of externally reported financial and sustainability information. **Financial reporting framework:** adopting a financial reporting framework that includes sustainability elements, including assessing the adoption of recognised reporting standards, linked to emerging climate change legislation/regulations. **Independent audit:** making use of independent audits of financial and reporting information by third parties.

4.6 Finance for the financial sector

The Finance process refers to the management of a company's financial cycle; its main aim is to govern financial risk[7] and achieve economic sustainability. This issue is common to all industries. Nevertheless, in this section, we focus on the aspects specific to the world of banking.

In this context, it is worth noting that this risk is one of the few already extensively regulated with respect to the management and integration of climate change risks and ESG risks more generally.

Starting from the definition of banking in the Italian Consolidated Banking Law (Art. 10(1)) as 'the collection of savings from the public and the exercise of credit', it becomes easier to understand that the Finance process of a bank takes on two meanings:

- 'real estate financing', typically the use of money in the form of investments in various capacities;
- 'funding' i.e. raising money.

7 Financial risk is the possibility that an investment or financial decision will not produce the expected results due to changes in financial markets, exchange rates, interest rates, inflation or other factors affecting the value of investments, resulting in a loss of capital or missed earning opportunities.

The table below provides a list of the climate change risks examined and a selection of related controls that banks can implement to respond to these risks, in both of the above areas.

Rischi Climate Change	
Risks	**Controls**
Physical risks - Passive (Acute and/or Chronic)	**Assessment and monitoring:** incorporating a **system for assessing and monitoring** extreme weather events that could cause damage and consequent impairment to the bank's assets and underlying investments, reviewing the existence of contingency and **business continuity plans**, the **geographical diversification** of assets, and assessing the **resilience** of properties exposed to climate risks.
Transition risks - Regulatory and legal constraints / Market-related / Reputational	**Governance and internal regulatory framework**: in order to mitigate reputational and greenwashing risks - linked to the possibility of investing in de facto non-green assets - it is essential to implement a **structured, well-organised governance** framework that emphasises the management and integration of climate risks into decision-making processes, as well as ensuring the existence of policies and regulatory frameworks aimed at mitigating the effects of climate risks and measuring their financial impact. **Transparency of information:** again, to reduce the risk of non-green investments, it is necessary to have full transparency of information when purchasing securities in order to be aware of the quality of the underlying assets (e.g. securitisations). **Reporting:** ensuring clear and detailed reporting as a means of effective communication to clients when issuing bonds; indeed, on the funding side, any issuance of non-green bonds could expose the financial institution to reputational attacks and litigation. **Training and information:** an essential element in building professionalism and promoting a culture of climate change. **Monitoring regulations:** safeguards identified to mitigate compliance and legal risks associated with both the sheer volume of existing laws and regulations and, more importantly, the constant enactment of legislation itself. **Integration of the Risk Appetite Framework, the definition of a funding plan and the existence of dedicated scoring systems:** interest rate risk and market risk have been examined, as these are risks that can arise as a result of events triggered mainly by reputational risk (stock market trends, bond market trends) and the strategic risk of not being able to implement all or part of the company's plans as a result of incorrect investment choices and identification of sources. **The inclusion of a specific Risk Appetite in the framework** and the existence of a detailed **funding plan**, including a deliberate diversification of the bank's portfolio, together with the existence of reliable **scoring systems** to determine the investment grade on which financial decisions can be made, can help to address strategic and market risk.
Reporting risks - Greenwashing	Reporting and communication system: implementing dedicated climate risk reporting systems and reviewing communication processes with investors and other stakeholders can lead to improved communication on climate risks, providing transparent and accurate information on the financial impact of such risks. Checks on the quality of data to be reported: The monitoring and control of data quality is a necessary safeguard to provide stakeholders and markets with sufficiently clear and transparent reports to allow them to invest and have confidence in the credit institution.

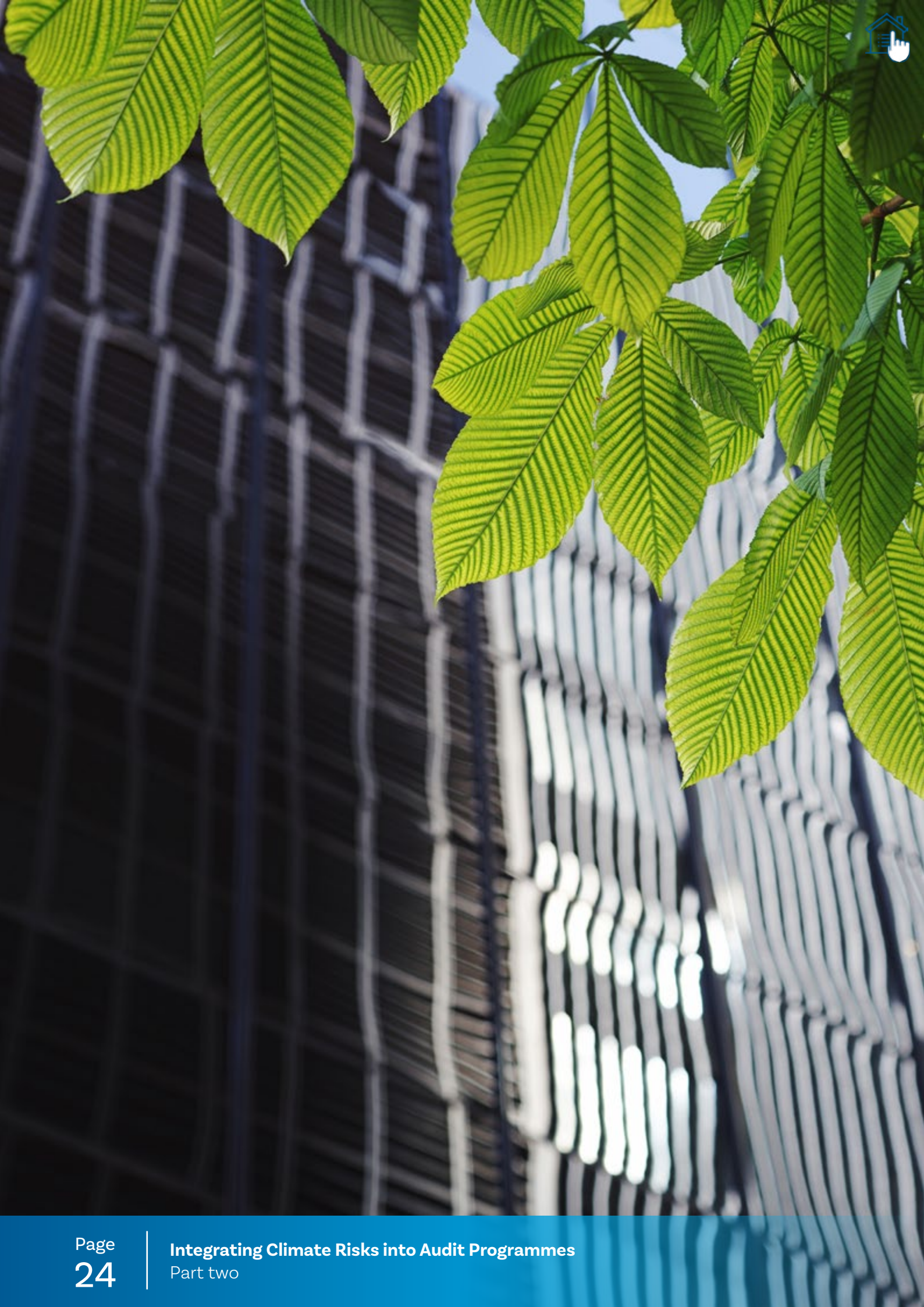
It is worth mentioning that the Internal Audit function can use **risk analysis** to conduct a detailed assessment of financial risks associated with climate change, for example assessing the bank's exposure and vulnerability to extreme climate events, as well as to regulatory changes and reputational phenomena related to environmental sustainability.

Finally, with a view to optimisation, the Internal Audit function can work with other bank functions, such as Risk Management, Compliance and Sustainability, to achieve an integrated view and comprehensive assessment of the financial risks associated with climate change, as well as to develop effective strategies for managing these risks.

Process control summary table

In Chapter 6, a table summarising the controls analysed (both in the preceding paragraphs and in Part One of the paper published in 2023) is available for ease of comparison and integration.

In a separate document the same table is available in a different format, optimised for horizontal viewing and printing.



5. Conclusions and next steps

The discussion on climate change, which the WG has been working on for the past five years, confirms that the growing concern of institutions, companies and public opinion is leading to a corresponding increase in the attention paid to these issues by Internal Audit functions.

However, this increased concern has not always been translated into measurable targets and coherent, concrete action plans within organisations. On the contrary, in some cases there has been a slowdown, also due to the complexity of the regulatory framework, which, however, is stabilising, at least in Europe, thanks to the introduction of the CSRD[8] , legislation that also contains certain references to the operational standards (ESRS[9]) to which medium and large companies will have to adapt in the next one to two years (ESRS E1 Climate Change).

Has the dialogue between CAEs and top management on the risks of climate change intensified in this scenario?

Has the time spent on these issues by the CAEs themselves and their teams increased?

Have environmental risks entered the Internal Audit Strategy as medium- to long-term coverage targets (and consequent skill-building and methodological upgrading plans)?

In 2021, we conducted a survey to understand the level of maturity with respect to climate change risks; the results[10] clearly showed that Internal Audit functions were at an early stage of addressing these risks at that time.

We now want to check whether the programmes and priorities of Internal Audit functions have changed in recent years. We will therefore soon be launching a new survey which will allow us to make comparisons and possibly identify new opportunities for further investigation.

As always, we'll need everyone's help!

8 Directive 2022/2464, the 'Corporate Sustainability Reporting Directive' was published in the EU Official Journal on 16 December 2022, replacing its predecessor Directive 2013/34 on non-financial reporting requirements for large companies; Member States are required to implement the Directive within 18 months of its publication.

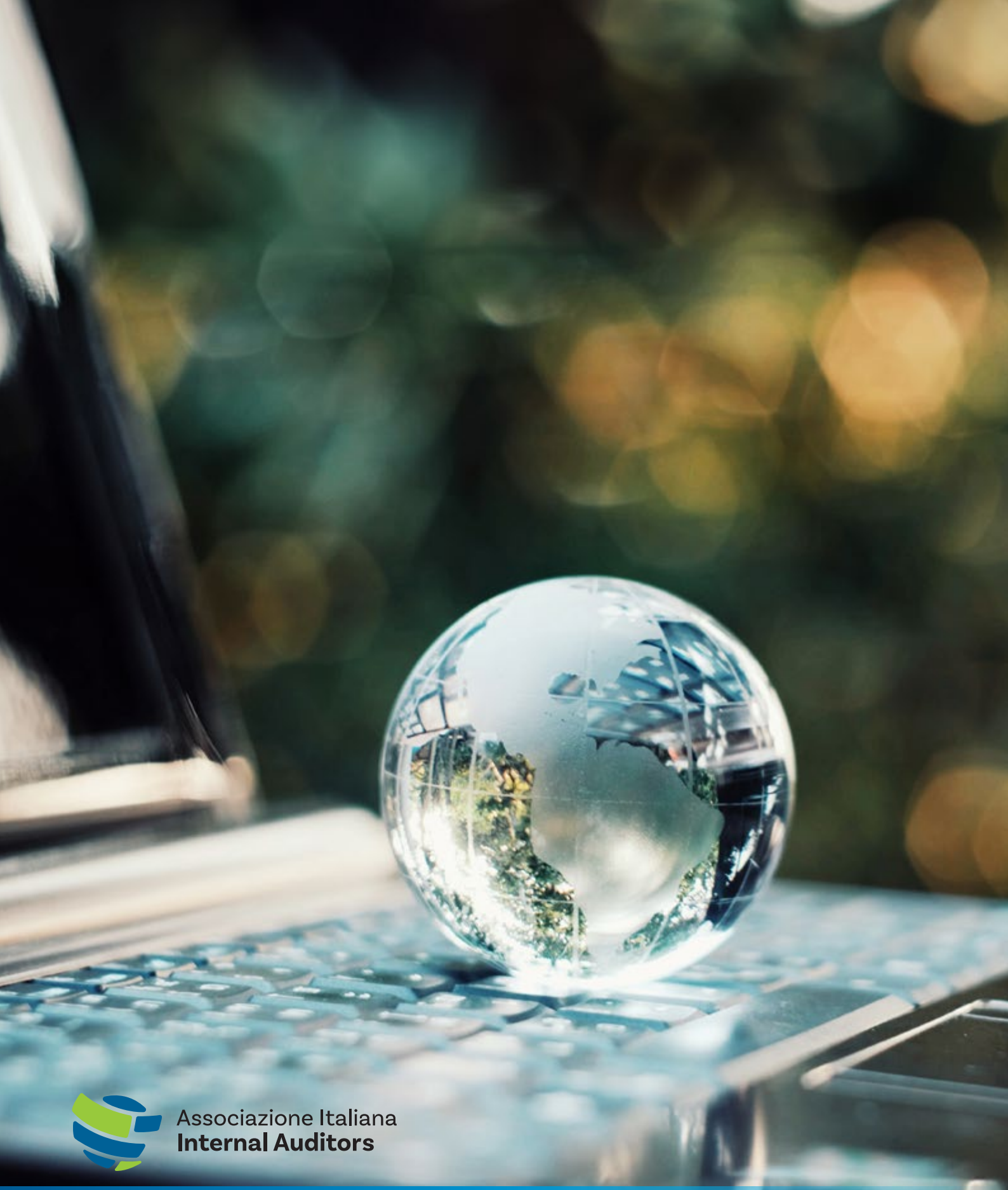
9 The European Sustainability Reporting Standards apply to all companies that have to report on sustainability, with reference to the reporting of financial statements starting from January 2024 onwards.

10 The results were reported in the 'Climate Change and Internal Audit Survey Report', published by AIIA in February 2022.

6. Process control summary

	Purchasing	HR	IT	Real Estate	New Product Development
Physical risks - Passive (acute)	• Geographical location of suppliers • Business continuity plans • Diversification • Market scouting	• Remote collaboration and connectivity • Business continuity plans Early warning • Monitoring	• Back-up and recovery • Business continuity plans	• Risk assessment (by geographical area and asset type) • Risk transfer (insurance policies)	• Resilience planning Business continuity plans • Sustainable sourcing
Physical risks - Passive (chronic)	• Self assessment e audit				
Physical risks – Active (emissions/ consumption)	• Audits on products/ processes/ materials	• Displacement analysis Flexible working policies Remote collaboration and connectivity • Sustainable mobility • Training and information	• Web design • Clean cooling • Training and information • Planning Monitoring	• Environmental policy • Monitoring • Contractual clauses	Stakeholder involvement: Clean by design and LCA - Life Cycle Assessment: • Monitoring • Scenario analysis • Risk Assessment and Planning • Continuous improvement: Training and information:
Transition risks - Regulatory and legal constraints	• Contractual clauses Service Level Agreement (SLA)			• Construction site control system • Monitoring	• Stakeholder involvement • Participation at institutional tables
Transition risks - Technological and product-related	• Partnerships • Supplier benchmarking • Training and information		• Planning Partnerships • Virtualisation and the cloud	• Sustainable design • Adopting efficiency standards • Scouting for new technologies	• Regulatory compliance
Transition risks - Marketrelated		• Flexible working policies • Communication plans • Organisation • Engagement • programmes • Recruitment and selection			• Access to capital
Transition risks - Reputation		• Communication plans • Social Media Policy • Performance Management		• Stakeholder management	• Verified communications
Reporting risks - Integrity and quality of data/ information	• Standards and tools Monitoring	• Standards and tools Monitoring	• Standards and tools • Monitoring	• Standards and tools • Monitoring	• Target setting and alignment • Standards and tools

	Marketing and Sales	Produzione	Logistica	Finance (companies)	Finance (banks)
Physical risks - Passive (acute)	• Scenario analysis • Contractual clauses • Auditing the availability of production factors (internal and external)	• Business continuity plans • Risk transfer • Measuring third party risk on the supply chain (direct and indirect)	• Business continuity plans • Risk transfer (insurance policies) • Infrastructure resilience analysis	• Diversification • Risk assessment and monitoring • Introduction of 'green' KPIs • Risk transfer • Financial business continuity plans • Credit analysis	• Assessment and monitoring
Physical risks - Passive (chronic)					• Evaluation and Monitoring
Physical risks – Active (emissions/ consumption)		• Measuring and monitoring environmental performance • Monitoring applicable legislation • Analysis of the current energy mix and alternative sources	Environmental optimisation of transport: • Market scouting Sustainable sour-cing • Maintenance • Monitoring		
Transition risks - Regulatory and legal constraints	• Regulatory monitoring Integrated product supply chain	• Monitoring applicable legislation • Participation at round tables • Training and information	• Procedures and policies • Training and information • Audits • Stakeholder involvement and participation at technical tables	• Governance and internal regulatory framework • Structured governance • Monitoring of applicable regulations • Training and information	• Governance and internal regulatory framework • Transparency of information Reporting • Monitoring regulations • Integration of the Risk Appetite Framework, the definition of a funding plan and the existence of dedicated scoring systems • Training and information
Transition risks - Technological and product-related		• Maintenance and investment plans	• Life Cycle Assessment (LCA) • Assessment of technological alternatives • Planning • Partnership		
Transition risks - Marketrelated	• Training, skills and information • Analysis and information tools • Integrated product supply chain and product positioning	• Capacity plans			
Transition risks - Reputation	• Communication strategies Verified communication • Certifications • Auditing business partners and outsourcers • Consumer/reference market education programmes				
Reporting risks - Integrity and quality of data/ information	• Data monitoring and verification	• Environmental reporting systems • Standards and tools	• Standards and tools • Monitoring	• Integrated financial reporting systems • Financial Reporting Framework • Independent Audit	• Reporting and communication system Checks on the quality of data to be reported



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