What Internal Auditors Need to Know about ESG Risks and Reporting

2022

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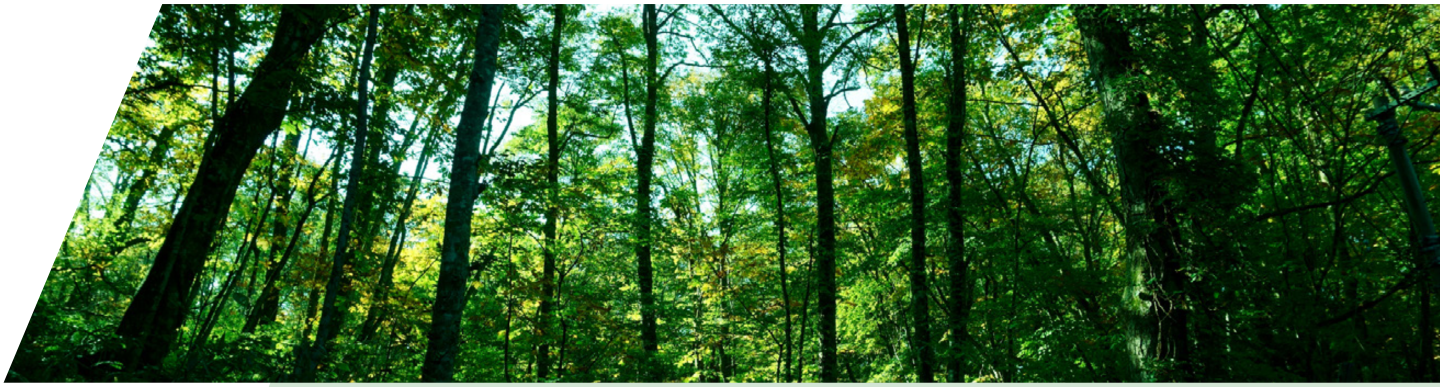

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At the Intersection of Internal Audit and ESG

By Hal Garyn

Internal auditors are busy folks. There never seems to be enough hours in the day to get through everything on the audit plan, not to mention the issues that seem to crop up all the time. These days, the topics that seems to be on the tip of everyone's tongue and the top of every regulator's mind are Environmental, Social, and Governance issues, commonly referred to as ESG.

Open your email and you're likely to see one or more messages about a webinar, article, exposure draft, regulatory development, or training on ESG. It can be so overwhelming that you might even want to delete them, keep your head down, and stick to your knitting. But as any good internal audit expert will tell you—ignore ESG at your peril!

As stated in the Institute of Internal Auditors' recent Global Knowledge Brief, The ESG Risk Landscape: Part One: "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."

What seems to be a dilemma for internal audit these days is looking in the mirror and asking what role it should play regarding ESG. Well, of course, just like most everything in life...it depends. So, let us explore the idea further.

Where Is Your Organization on ESG?

Before we start to think about what role internal audit should play when it comes to ESG, we must first gain a full understanding of where the organization stands when it comes to the topic. Certainly, the industries the organization competes in will be a big factor, as well as the counties where it does business. Those are, to an important degree, contextual givens that need to be navigated.

Another important factor is: what is the organization thinking when it comes to ESG? And that might differ with each component: the E (environment), the S (social), and the G (governance). How much of ESG reporting will be strategic and how much of it will be tactical compliance? How much of it will be to create a strategic advantage among one or more stakeholders, versus how much of it will be to do as little as possible to just comply and keep critics and regulators at bay? Is the organization looking to be a leader, setting the tone for competitors? Or is it content to be a follower, watching what competitors do first?

Understanding where the organization's "head" is on ESG would be the first thing to do. It provides context, and it allows internal audit to challenge if that "strategic versus compliance oriented" stance is consistent with the organization's mission, vision, and values, as well as what the board expects. And it allows internal audit leaders to make sure the board and the organization's strategic plan is considering ESG in a way that is consistent with those ideas. Misalignment at this level can cause a number of issues that will crop up in internal discussions as tactical disagreements on the right path forward and what is or is not important. If internal audit understands the strategic mindset of the organization, it may also be able to help facilitate and broker some of the tactical disagreements on ESG that are sure to arise and help the organization keep on its desired path.

So, start here. Understand where your organization's "head" is. And, as time goes on, do a strategic "gut check" to make sure that what your organization is doing as it relates to ESG remains consistent with the company's approved strategic plan. Next, track what your competitors are doing so that you can raise questions internally to test whether the strategy around ESG is still appropriate.

"Clearly, the ESG reporting landscape is complex and evolving."

Internal Audit's Part to Play

Once the overall ESG mindset and goals are established, internal audit can carve out its role in helping the organization meet those goals. There are two very distinct and important roles for internal audit when it comes to ESG. Hopefully the organization is supportive of the internal audit participating in both spaces. Those roles are: 1. Advisory, and 2. Assurance. Simple, right? Well, not exactly.

First, the internal audit staff needs to have the skills and knowledge to contribute. Yes, as IIA Professional Standards call for, competence does mean a lot for internal audit's credibility with each of these separate and distinct roles. If internal audit doesn't have the skills and knowledge, the organization should first provide the resources needed to

"What does this particular constituent expect of us with regard to the E, the S, and the G?"

acquire that competence, either through direct hire, rotational staff, or third-party co-sourcing.

Before you do any work, though, think about basic economics: You cannot just supply the competent resources, there must be a demand for those resources. The meaning here is that internal audit must be viewed as being able to add value and make a difference by contributing to the organization's ESG approach in an advisory and assurance capacity. Look, you can knock on the door all you want, if your organization does not view it as "opportunity knocking" they will not answer the door!

Now it is time for the rubber to meet the road. Is internal audit going to do advisory work—making sure the organization has the right numbers? Or is it going to do assurance work—making sure the numbers are right? Or both?

Putting the Horse Before the Cart

Before internal audit can consider assurance projects, hopefully it is well positioned to do advisory work. Again, let us make sure the organization is identifying the right data (determining whether the data is actually right comes later). So, how can internal audit help to ensure the organization is identifying the right items to report in terms of the "E" component, the "S" component, and the "G" component? Let us start with identifying all the constituents the organization serves.

Why start with constituents? Well, each constituent will have a different lens through which they view the organization, and their expectation of the organization may vary based on their relationship with the company. Some of the constituents you identify will include: customers, current employees, future employees, vendors, investors, creditors, insurers, regulators, and others.

Take each one of these identified constituents separately and ask yourself, "what does this particular constituent expect of us with regard to the E, the S, and the G, and what information could we be sharing with them that would make them feel good about our approach to our responsibilities and obligations as a corporation?" I did say "could," since this is brainstorming, and what could be disclosed may not be what should be disclosed. This will result in a rather comprehensive list of items to discuss with organizational leadership.

It is also important to consider what competitors are doing on ESG, or what they are discussing doing. The best place to get this type of information may be through industry networking, peer groups, roundtables, conferences, and other professional gatherings. Consulting firms are another valuable source to keep your finger on the pulse of what competitors are doing or considering.

An additional place where internal audit's talents can be put to skillful use on ESG is to advise on the processes and procedures around data collection, validation, and approval. These routines should be well established, with the right internal controls, to help assure company leadership and the board that good data will be collected, and accuracy can be reasonably assured.

Throughout all this advisory work, never forget to collaborate with key functions like compliance, legal, and IT, as well as any other key functions in the organization to include all relevant aspects of operational and financial management.

Even if you have already shifted to doing assurance work on the actual ESG disclosures already being provided, that does not abdicate your roles as top questioner and trusted advisor to your organization as you provide advisory services across the ESG landscape.

OK, so there is plenty to do in terms of advisory work and truly positioning yourself to add value. Ask the questions around "is it the right data" before concerning yourself with "is the data right?"

But Wait, There's More

Yes, in the end, we are also expected to provide assurance over ESG. Regardless of whether it is the right data, if we are reporting something to the world outside of the organization, is what we are reporting correct? Assessing the accuracy, voracity, and verifiability of the data is a role well suited to internal audit. That is an assurance role, and it is right up our alley.

Let us establish, as best as we can within the organization, it is not internal audit's responsibility to get operational. Operational aspects of ESG data collection and reporting should be avoided as much as possible. This is not the time to go down the SOX path and end up having internal audit with operational duties related to external reporting and the infrastructure to support it.

On the flip side, though, also avoid bayonetting the wounded by applying hindsight to audit on data that has already been reported in past periods. That just gives us a bad name and reputation.

To avoid doing too much auditing on previously reported numbers and statistics, focus on the procedures, processes, and documentation established for existing and decided upon disclosures. In essence, you will recognize this as evaluating the design of the controls and asking, is the design adequate to produce reliable, verifiable, and consistent data? Providing assurance on the design will help the organization avoid future reporting errors and position internal audit to add value to the organization and truly make a difference.

It generally will be difficult to provide assurance on what is going to be reported while it is "in flight," as there will likely be tight time windows between data collection, internal operational review, and actual external reporting. But, if that is possible, at least on the highest risk disclosures, then that is much better than doing assurance work on previously reported data and statistics.

This all leads to a potential final area of work for internal audit: doing a risk assessment on the data that is already being reported. Not all disclosures are created equal and some will create a lot more risk to the organization if there are inaccuracies than others. So, with limited time, focus on the high-risk disclosures and share your risk assessment of the ESG disclosures with the organization. That will create interesting and valuable dialogue and might make the organization think differently about what and how it is disclosing ESG information. Or, at a minimum, it will educate you and your staff on the thought process the organization is going through as part of its ESG reporting cycles.

What Did We Miss?

You're not done though. A wise place to pivot to is to consider what areas the organization is not paying enough attention. Most of the focus these days tends to overweight the environmental component of ESG. Especially with all the rightful attention being given to climate change concerns and the regulatory pressure for disclosures on climate matters. Don't forget the social and governance aspects. That does not mean you should take your eye off the environmental facets. Not in the least. But, with all the focus on the E, it is quite possible not enough attention is being placed on the S or on the G components. Take the effort to give special thought to the social and governance aspects of what the organization could be reporting on. There are several issues under these topics that will have true and valuable meaning for many of those stakeholders you previously identified.

If you have been in internal auditing long enough, you have seen many acronyms come and go. But, in this case, it looks like the ESG train is picking up steam and will be with us for good. So, stake out your role, be strategic, provide advisory work, and follow with assurance work. Make sure your audit plans consider these key roles and that your audit committee supports your efforts. Have or obtain the necessary competence. And make sure that data is not only right, but that it is the right data. And, more than anything else, continue to position yourself to add value and make a difference. That is our job.

Hal Garyn is Managing Director and Owner of Audit Executive Advisory Services, LLC based in FL.

As New Rules Loom, Internal Audit's Role in ESG Reporting Under Review

By Karen Kroll

The Securities and Exchange Commission is currently working on new rules that would require public companies to say much more about their climate-related initiatives. Until now, most environmental, social, and governance disclosures have been voluntary. The SEC proposal has put internal audit functions on alert at the prospect of the biggest change in reporting requirements since the Sarbanes-Oxley Act was passed in 2002.

In advance of the likely new rules, companies are now re-examining their preparedness to meet the requirements. If adopted, the new rules will require companies to report on:

1. The company's processes for identifying, assessing, and managing climate-related risks.
2. How climate-related risks identified by the company materially impact its financial statements, strategy, business model, and outlook.
3. Specifics on the company's greenhouse gas emissions.
4. How the board and management are overseeing and governing climate-related risks.
5. Details on the company's public climate-related targets or goals, including any use of carbon offsets or renewable energy certificates.

While the rules would drastically overhaul the information companies must provide on their sustainability and social justice initiatives, the ideas behind them are hardly new. The concepts behind ESG initiatives have been around since at least the 1960s, when activists pressured companies to stop production of napalm. In the 1970s and '80s, much of the focus shifted to persuading companies to divest from South Africa because of its system of apartheid. More recently, climate concerns over the use of fossil fuels have given way to investment funds in excess of an aggregate $3 trillion that consider ESG criteria in investment decisions.

The Demand for Information

While ESG boasts a decades-long history, over the past few years it's moved further into the mainstream. "Clients, as well as job candidates and current employees, are asking more questions about ESG issues as it becomes more of a priority for them," says Phil Benvenuti, senior director of internal audit at software company Pegasystems. "Not having a documented, sustainable, and evidence-backed comprehensive ESG program can put companies at a disadvantage in bringing in new customers and employees."

A solid ESG program also is becoming more of prerequisite to attract capital from investors, says Matt Orrell, partner in the financial services practice at accounting and advisory firm PKF O'Connor Davies."

Businesses are responding. As of August 2021, 95 percent of the S&P 500 provide some detailed ESG information publicly, the Center for Audit Quality (CAQ) reports. For most, the information was outside their SEC submissions, often in sustainability, corporate responsibility, or similar reports.

Yet even as more companies report on ESG initiatives, many are not gaining assurance—either from an outside audit firm or from the company's own internal audit function—on the information they're publishing. Just over half (51 percent) of organizations reporting on ESG obtain some level of assurance, according to a report by the Institute of Internal Auditors and consulting firm EY. In about 35 percent of organizations, internal audit had no involvement in ESG disclosures at all.

Many industry observers say that needs to change. "Internal auditing teams should be considered the fiduciary 'boots on the ground' that oversees the practical day-to-day execution of the specific E, S, and G strategies laid out at the governance level," says Jeff Hood, founder and chief executive officer at Theia Analytics Group, a provider of analytics solutions.

Senior management would likely be far more comfortable reporting statistics on ESG after an independent, objective team has reviewed it, says Jorge Green, senior director of internal audit at cabinet maker American Woodmark Corp.

Increasing Focus on ESG

One reason? An organization's reputation can be tightly linked to its ESG performance, says Glenn Sumners, director of the Center for Internal Auditing at Louisiana State University. "If you audit payroll, you probably won't impact the organization's reputation. That's not so with ESG."

Moreover, regulatory agencies around the world and beyond the SEC are zeroing in on ESG. The European Commission's proposal for a Corporate Sustainability Reporting Directive (CSRD), for example, aims to improve the flow of sustainability information in the corporate world and make sustainability reporting more consistent.

Internal Auditors' ESG Role

Internal auditors are uniquely positioned to review their organization's ESG impact against leading standards and frameworks and determine whether the reported data provides reliability, comparability, and relevance, says Maura Hodge, audit partner and national ESG assurance leader at audit and consulting firm KPMG. They can help identify risks and address the questions top decision makers must consider, such as: What are our controls around ESG data collection? Are we reporting ESG data in line with industry standards and our peers?

Similar to many other steps internal audit might take to protect the organization, its mission with ESG is to identify issues and make recommendations for remediation before an audit or inspection by an outside entity, Benvenuti says. If internal audit is responsible for auditing the enterprise risk management (ERM) program, it should ensure the risks addressed by the ESG program are part of the ERM program, he adds.

As the program at Pegasystems matures, the internal audit function will audit against what the company says it's doing, Benvenuti says. This could be in the form of a broad internal audit engagement, or as part of a larger internal audit. For instance, auditors might fold a review of elements of inclusion and diversity into a larger internal audit around HR processes.

Macro Challenges to Auditing ESG

To be sure, internal audit departments auditing ESG programs likely will face several obstacles. "While the 'why' of ESG is clearly understood, we are finding that companies are still challenged by how to envision, implement, and grow their ESG strategies and by what to report," Hodge says.

One reason is the lack of a uniform framework, although there's been "slow but steady progress" in converging multiple ESG reporting standards, Hodge says. In June, the IFRS Foundation completed its absorption of the Value Reporting Foundation and established the International Sustainability Standards Board (ISSB), a sister body to the International Accounting Standards Board (IASB). This consolidation "will help put sustainability reporting on the same footing as financial reporting," she says.

The SEC indicated that its proposed climate-related disclosure framework is modeled in part on recommendations made by the TCFD, or Task Force on Climate-Related Financial Disclosures. The TCFD was established by the Financial Stability Board, which coordinates internationally the work of national financial authorities and international standard-setting bodies.

The European Union has proposed the EU Taxonomy, a transparency tool that introduces mandatory disclosure obligations under the Sustainable Finance Disclosure Regulation and the CSRD, Hodge says. This will allow investors to compare companies and investment portfolios.

"All three standard setters must work together to determine which components of each standard would be building blocks, with the others adding relevant jurisdictional requirements," Hodge says.

Internal Challenges

Many internal auditors likely will face obstacles within their organizations. In organizations in which internal audit doesn't have a seat at the ESG table, it may be less able to effectively align and provide assurance for key ESG risks, Hodge notes.

As internal audit begins working with subject matter experts who are new to the audit process or lack familiarity with the detailed level of information required, change management challenges may arise, says Michelle Uwasomba, partner at audit and consulting firm Ernst & Young LLP.

ESG topics like climate change and decarbonization have not historically been part of traditional audit plans, Uwasomba says. "Understanding what 'good' looks like so that you can better serve the business will be more challenging," she says.

On a practical level, the data required to review ESG reporting often is minimal, unavailable, or scattered across multiple departments, says Liz Gousse Ballotte, a partner with PKF O'Connor Davies. Some data may be tracked manually and not fed into centralized data

"An organization's reputation can be tightly linked to its ESG performance."

systems or it could be siloed in various parts of the organization. These can make assembling and reviewing information more difficult.

And ESG initiatives may not have as a quantifiable impact as, say, a new accounts payable system, Benvenuti says. Even so, the risk of not having a program has to be addressed, he adds.

Steps to Take

To meet these challenges and provide robust assurance, many internal auditors will need to develop new areas of expertise. "Auditors need to become familiar with items such as Green House Gas (GSG) Calculation Frameworks," Green says.

In the short- to medium-term, many internal audit teams will need to leverage internal or external technical sustainability experts, particularly for more technical aspects of ESG information, like injury reporting, Uwasomba says.

Internal auditors also will need to gain expertise in testing IT systems and relevant data elements that are used in ESG reporting, but not previously used in financial reporting, Hodge notes. They'll also need to engage with current process owners, understand how information is defined, where control gaps exist, and explore options to create efficiencies and move certain aspects of data collection and calculations into systems and processes already controlled within the parameters of Sarbanes-Oxley, she adds.

It's a daunting to-do list. Fortunately, the internal audit profession has a great network of professionals willing to share ideas and strategies, Benvenuti says. External auditors also are good sources of information on steps other companies are taking, he adds.

Investing the time and energy required to gain a greater understanding of ESG can benefit both companies and internal auditors. "You don't get a lot of visibility auditing HR," Sumners says. ESG, however, will attract lots of attention from the board, he adds.

Among businesses and organizations, early adopters will gain a competitive advantage as ESG reporting becomes more prevalent and consistent, Green says. "People like to be associated with responsible and environmentally-conscious companies," he says, adding that he's "excited to be part of the change."

In the United States, the SEC recently asked for comments on changes to securities laws that "would require registrants to provide certain climate-related information in their registration statements and annual reports." What those final rules will look like is still anyone's guess. What is more certain is that internal audit still has a great deal of work to do to prepare to help their companies comply with them.

Karen Kroll is a finance and business writer based in Minneapolis, Minnesota.

Carving out internal audit's role in ESG reporting

By Kevin Gould

Environmental, Social, and Governance (ESG) is a framework that has become increasingly popular in recent years. Many organizations recognize that adapting to changing socio-economic and environmental conditions is not only good reputationally, but it also enables them to better identify areas of potential risk and growth opportunities. Stakeholders are also expecting more from companies beyond profits.

McKinsey & Company, a global management consulting firm, believes ESG should be an "inextricable part of how you do business." The firm asserts that while implementing an ESG framework is necessary, it can also lead to a more sustainable business and better value creation. In a recent publication, McKinsey & Company stated ESG links to value creation in five critical ways: top-line growth, cost reduction, lower regulatory and legal intervention, productivity gains, and better investment decisions.

As a result, internal auditors feel a need to play a key role in their organization's ESG practices. However, many internal auditors struggle with where to begin. TeamMate Audit Benchmark insights found that 55 percent of respondents do not currently include ESG in the audit plan. The encouraging news is that of these respondents, about half expect to do so in the next two years. This clearly indicates a building momentum toward increased audit work on ESG issues.

Another obstacle can be getting senior management on board. Internal auditors have a responsibility to highlight both emerging risks and risks not being mitigated or addressed by the organization. Although the best approach to ESG will depend on the organization's culture, taking small steps is often an excellent way to get senior management buy-in. For example, mention a few ESG risks in the audit committee pack if you have a section on emerging risks or add steps

to existing audits that highlight gaps in controls. ESG doesn't need to be a single assessment. It encompasses a wide range of risks spanning a wide range of issues. While it can be a single audit, it doesn't need to be and can be included in one or many existing audits.

As you move toward incorporating ESG into your audit plan, it can be helpful to consider it as part of your risk assessment. How you go about this will depend on a range of factors, especially how your organization approaches ESG and its level of maturity. To start, keep it simple and think about ESG as an overlay to your existing risk assessment. You can go back and integrate it in more detail later. Focus on big issues that can deliver quick wins to maximize the impact and value of assurance. There is no right or wrong.

As auditors, we can do both standalone work and work where ESG factors integrate into our existing audit planning, so do what is best for your organization.

Overall, ESG presents a real opportunity for internal audit to make an impact. Personally, I'm passionate about the environment, inclusion, and social justice. But even if you don't have the same personal motivation, these risks are real. And momentum is building from stakeholders and other external parties. ESG should be viewed as an opportunity for internal audit to raise its profile as a trusted advisor by using its expertise and influence to ensure organizations are identifying and mitigating risks around this important area. ●

Kevin Gould is an internal audit consultant and a non-executive director and audit committee chair on several boards. He is also a Chartered Accountant with a strong background in Internal Audit and a recent focus on ESG. He has 25 years of experience as a consultant, adviser, and auditor.

Internal Audit Must Provide Greater Assurance over ESG Reporting

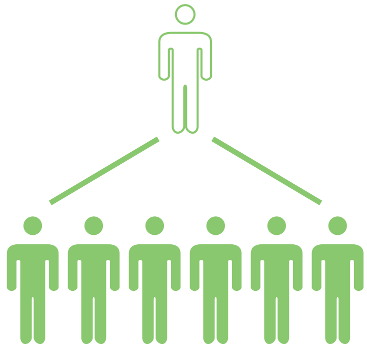
By Joseph McCafferty

A new survey found that two-thirds of organizations have an ESG program in place and another 24 percent have plans to implement one. However, only half (51 percent) of organizations that report on ESG obtain some level of assurance from their internal audit functions. So, while companies may be listening to investors and other stakeholders, who've been sounding the ESG alarm thanks to climate change, diversity, equity, and inclusion (DEI) issues, they still have some work to do to get internal audit involved in the effort. "Increasingly, boards, employees, and investors want to know how companies are driving long-term value through ESG management in the organization's strategy, performance, and value creation," say the report's authors.

The study, Prioritizing Environmental, Social, and Governance (ESG) – Exploring Internal Audit's Role as a Critical Collaborator, produced by the Institute of Internal Auditors' Internal Audit Foundation in collaboration with Ernst & Young summarizes findings from a survey that examined how organizations are using their internal audit functions to support ESG initiatives and build confidence in these increasingly relied upon disclosures.

"Internal audit functions are a critical pillar supporting an organization's processes and data for ESG performance and reporting," said Brad J. Monterio, The IIA's executive vice president of member competency and learning and also a sustainability expert and member of the International Integrated Reporting Council. "Internal auditors provide the independent internal assurance needed for trustworthy ESG disclosures, and help ensure the effectiveness of continuous monitoring processes and internal controls across the organization. Their role complements that of the external auditors and builds confidence among users of ESG information for investment or other decision making."

Impending regulation and market shifts are also driving greater focus on ESG. The U.S. Securities and Exchange Commission (SEC) indicated it is on the path toward regulating climate and ESG disclosures. The SEC also created a Climate and ESG Task Force to identify ESG-related misconduct, and shared example letters regarding climate change disclosures. At the 26th United Nations (UN) Climate Change Conference (COP26), the International Financial Reporting Standards Foundation (IFRS) announced the new International Sustainability Standards Board (ISSB), which will set recommendations for ESG reporting.



The internal audit function's contribution to ESG efforts is influenced by, and dependent on, the organization's ambition, strategy, programs, and reporting in ESG:

62% of chief audit executives (CAEs) said boards of directors are driving the organization's focus and integration of ESG strategy and reporting.

65% of CAEs indicated their internal audit functions have some involvement.

The survey also identified barriers to internal audit involvement in ESG efforts, including a lack of available data to support ESG engagements and the need to make ESG part of an organization's culture.

For their part, CAEs outlined two steps that would help address these issues:

>50% of CAEs said their organizations need greater focus on ESG-related risks on the enterprise-wide risk assessment and that boards and C-suites should mandate that their internal audit function participate in ESG efforts.

44% stated that regulations and regulatory compliance requirements are needed.

"As the ESG market and regulatory landscape continues to rapidly accelerate, internal audit functions have a key role to play in supporting its organization's risk management and performance with controls assurance," said Shannon Sullivan Roberts, principal for climate change and sustainability services at EY. "This report begins to investigate the current state of internal audit's role and how it may advance in years to come as ESG becomes an integrated part of business to drive long-term value." ●

Joseph McCafferty is editor and publisher of Internal Audit 360°

ESG Planning for Internal Audit in Three Easy Steps

By Wolters Kluwer TeamMate

The world of environmental, social, and governance (ESG) compliance is moving from nice-to-have to need-to-have. Organizations that fail to understand ESG risks and that don't provide clear ESG reporting face potential consequences like falling behind competitors and losing stakeholder trust. Meanwhile, regulators are moving toward making ESG disclosures mandatory.

For example, the Securities and Exchange Commission (SEC) proposed new rules in March 2022 that would mandate climate-related disclosures, for example, a company's governance of climate-related risks.

"Until now, most environmental, social, and governance disclosures have been voluntary. The SEC proposal has put internal audit functions on alert at the prospect of the biggest change in reporting requirements since the Sarbanes-Oxley Act was passed in 2002," notes the article, "As New Rules Loom, Internal Audit's Role in ESG Reporting Under Review," page 8.

Meanwhile, other stakeholders like customers and employees have come to expect more ESG commitments, around diversity, equity, and inclusion (DEI), and sustainability topics like emissions reductions. Organizations that falter could face employee and customer turnover, as they instead turn to competitors that excel in these areas.

"Three-quarters of U.S. adults care about a company's impact on the environment when making purchase decisions, and 68 percent say the same of efforts to promote diversity and inclusion in a company's workforce and customer base," finds a Gallup survey.

So, even if ESG compliance is not required yet, there's good reason to adopt best practices as early as possible. And given how many areas of a company ESG issues touch—and that governance is literally in the name—it makes sense for internal audit to incorporate ESG into its overall assurance responsibilities.

1. Determine Responsibility

The first step in creating an audit plan that incorporates ESG factors is to figure out who's responsible for what and see if any roles need to shift. Nearly two-thirds of chief audit executives (CAE) said that boards drive their organizations' "focus and integration of ESG strategy and reporting," according to a study by The Internal Audit Foundation, The Institute of Internal Auditors (IIA), and EY.

That might work at some organizations, but it could also be the case that your internal audit team is well placed to assume this responsibility, or at least take on a larger role than what you're currently handling. That same study found that over half of CAEs think "boards and C-suites should mandate that their internal audit function participate in ESG efforts."

And because ESG issues touch so many areas of business, it's important to know who to turn to in order to get the right information about ESG risks and ESG compliance. Reviewing current roles and responsibilities might lead to identifying gaps, like if senior management becomes so focused on the "E" and "S" of "ESG" that the governance angle is overlooked.

2. Get a Lay of the Land

Developing an audit plan that incorporates ESG factors often requires internal auditors to gain a better understanding of ESG issues. That's not to say that every internal audit member has to be an expert about everything related to ESG, but it helps to at least get a lay of the land, comparable to how you might brush up on cybersecurity to provide better IT assurance.

To do so, internal auditors might turn to internal sources, like meeting with HR to discuss DEI issues or operations teams to understand if or how emissions are being accounted for. Externally, internal auditors might turn to industry reports, to review other companies' ESG disclosures or discuss ESG risks with external auditors.

Because of the complexity and many arms of ESG, organizations might also need to bring in additional expertise through hiring or consulting arrangements, to better understand ESG risk and ESG compliance needs. Doing so can help organizations determine what ESG data is already available and what needs to be calculated.

3. Communicate ESG Risk

Gaining an understanding of ESG risks is only part of the process for internal audit teams. You also need to be able to communicate ESG risks to stakeholders like senior management. Long-term, your goal might be to develop a separate ESG risk report, but for now, it might be more realistic to incorporate ESG risk reporting into your current processes.

In doing so, keep in mind that this may be a new area for those receiving risk reports. That's why it might not be practical to start with, say, a deep dive on your Scope 1 vs. Scope 2 vs. Scope 3 emissions. Instead, you may need to fold ESG risks into more familiar, traditionally used areas and then layer in additional ESG metrics over time.

For example, when sharing financial risks with executives during an internal audit presentation, you might point out how shortcomings in ESG principles could hurt consumer demand, thereby decreasing top-line revenue. Or, when discussing legal risks, you might include information on emerging ESG compliance regulations, such as proposed SEC rules, that prompt leaders to expand legal or compliance budgets.

Prioritize ESG

Internal audit teams that prioritize ESG risk management now can position their organizations to navigate changing stakeholder expectations and be better prepared as new ESG compliance rules take shape. Public companies or those who are fundraising can also make themselves attractive to those interested in ESG investing.

ESG objectives tend to evolve. The sooner you're able to implement these factors into your assurance processes, the better. It's important to understand who's responsible for ESG policy and the various ESG practices within your organization. By developing a solid understanding of ESG issues, and applying a robust communication strategy with stakeholders, you'll have a greater opportunity to build a strong foundation; one that increases your organization's appeal to stakeholders, from institutional investors to individual customers. ●

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Q&A: What Internal Audit Needs to Do about ESG Risks

By Ian Beale

Consumer and investor awareness about sustainability is higher than ever, but misleading claims by enterprises to address this can damage an organization's reputation.

We recently sat down with Ian Beale, VP, Advisory at Gartner, to discuss greenwashing: where organizations intentionally, or not, mislead investors, regulators, and the public about the impact of their products and services on the environment.

Q: Why have concerns about greenwashing risks accelerated in 2022?

A: As a result of the alarming climate changes on our planet, companies are expected to actively and visibly play their part in accelerating their moves to a carbon free world. Hence consumers, investors, regulators, employees, and the media are more focused than ever before on what companies are saying and, even more importantly, what they are doing—whether they are doing enough, whether they are acting on it fast enough, and whether they are accurately telling the whole story in their public announcements.

Q: How might organizations be exposed to greenwashing risks?

A: CEOs may make pronouncements about their companies' performance and plans; they may sign up to protocols and commit their companies to certain goals, targets and timelines. They may do this because they feel it is the right thing to do or, more cynically, to try and gain a competitive edge. However, unless there is genuine commitment, investment, resources, and the project

management process in place to achieve these goals (and to ensure that they are the right goals), there are risks that poor goals are chosen, company strategy is not aligned to the goals, resources are not committed to the right activities and targets will be missed.

If statements are made, and not delivered upon, or inaccurate information is reported (intentionally or through carelessness) there will be a swift and negative impact in today's world of 24/7 news and immediate social media commentary. Consequences could be more severe in relation to investors and whether a company is considered "investable" by ESG mandates. In addition, moving towards a carbon neutral or carbon negative world, for example, offers enormous business opportunities, but those upsides could also be missed without appropriate strategy, governance, management, and reporting.

Q: What role should internal audit play in identifying and mitigating greenwashing risks?

A: Firstly, audit can challenge the commitments being made by management. For example, is management making genuine and substantive commitments to meet the right protocols and adjusting those commitments as new protocols that are announced e.g. by the UN, or others? Is management aware of the regulations to which they need to comply and making optimal decisions where regulations appear to conflict or overlap?

Internal audit leaders should ensure that the right management teams (in terms of seniority and expertise) are clearly responsible and empowered to deliver the necessary activities quickly enough. They should also check to see that progress and performance are being reported accurately and consistently internally, and that appropriate metrics are being fully, accurately and honestly reported externally with appropriate context.

Q: Can the above be accomplished through enhancing existing internal audit processes, or do organizations need specialized controls for this risk?

A: These approaches use standard audit techniques to understand a process, assess the risks to the satisfactory achievement of stated goals, and to map the controls needed to mitigate those risks within an agreed and defined acceptable tolerance. This approach must also use audit skills to identify and collect data, to challenge management, to robustly critique their plans and statements, to maintain independence (while being a critical friend in this fast-changing area) and to interact professionally with senior management are also all essential.

There is clearly a need for many teams to upskill in specific ESG areas that are most critical to their organizations, to be able to adequately assess management statements, their activity and system data. That is always needed for any new and evolving complex risk area.

Ian Beale is a VP, Advisory with Gartner's Audit and the Risk Leadership Practice, where he supports leaders of risk and audit functions throughout EMEA.

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