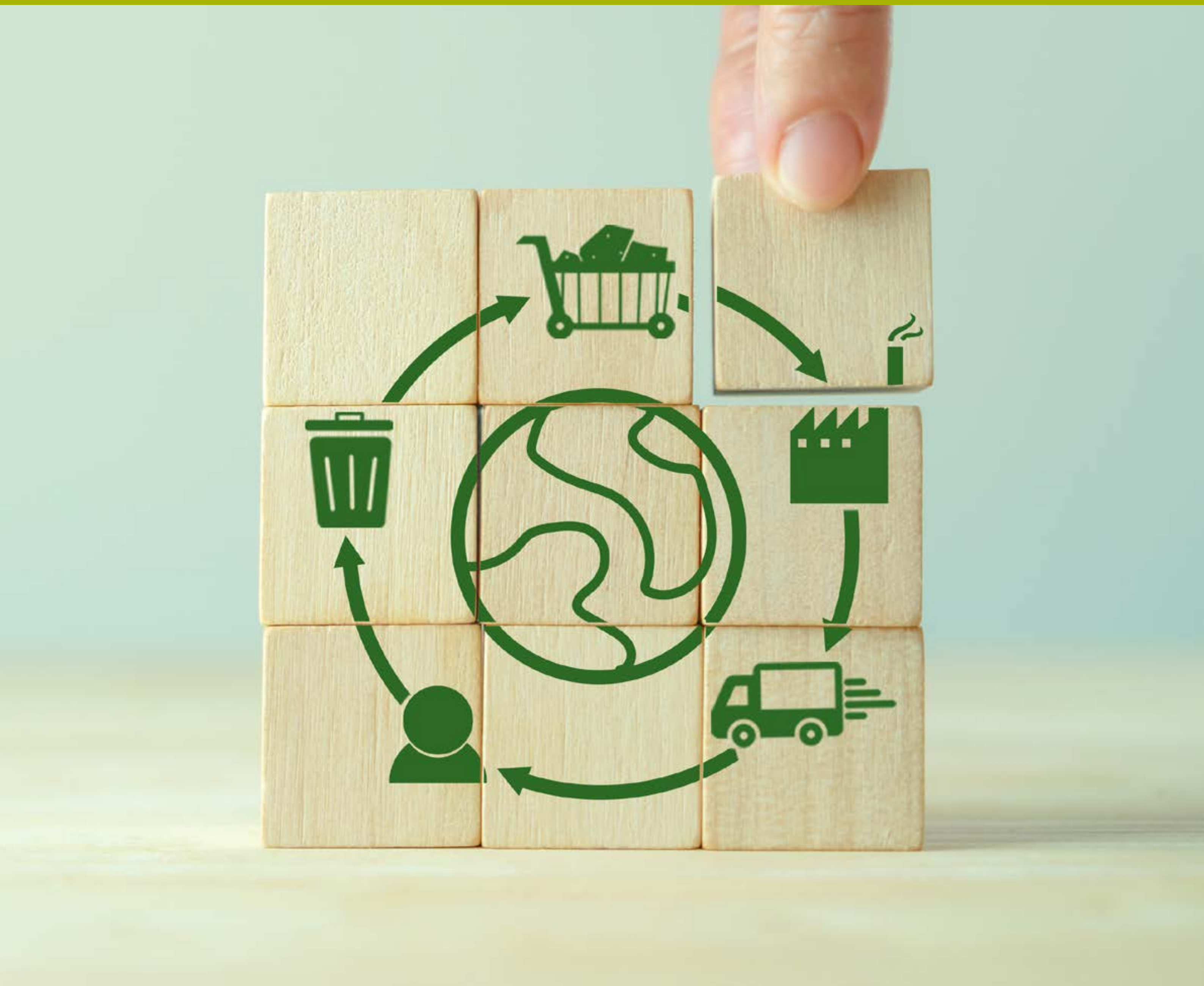
Chartered Institute of Internal Auditors

AUDITBOARD

Supply Chain Risk Part 1

Supply Chain ESG Risks: Harnessing the Potential of Internal Audit



Foreword

In an era where sustainability, ethical practices, and transparency have become integral components of responsible business, the intersection of environmental, social, and governance (ESG) issues within supply chain management is undeniably a critical risk area for organisations.

Organisations now face the challenge of trying to align their supply chain operations with their ESG values, targets, and ambitions with other parts of their business strategy. This is becoming increasingly important as stakeholders, regulators, and customers demand greater transparency and accountability for organisations' ESG practices within their supply chains. The need for due diligence when engaging and selecting suppliers has also become a vital aspect of organisational operations. Internal audit has a role to play in this area, particularly in providing assurance and supporting due-diligence activities, to ensure that these risks are being identified, managed and mitigated effectively.

This report aims to provide a deep dive into the relationship between ESG risks and the due diligence activities within the supply chain with a focus on how internal audit could provide assurance against these risks. One of the key takeaways from the report is that supply chain expertise is in short supply across organisations, particularly within internal audit functions. By providing assurance, scrutinising compliance, conducting risk assessments and providing recommendations for improvement, the internal audit profession can help their organisation in this challenging landscape.

The first part of this report examines the multifaceted impact of environmental issues on supply chains where important issues such as Net Zero commitments and biodiversity loss are highlighted. Secondly, the report evaluates the social and governance issues within supply chains including human rights, labour practices, and the fight against corruption. The final part of this report examines how internal audit functions can measure the effectiveness of an organisation's ESG risk management program.

The recommendations and insights presented in this report are not only timely but also of significant importance, particularly given the 2023 United Nations Climate Change Conference (COP28) in Dubai. With the renewed focus on the climate change challenge, now is the time for boards, audit committees, and internal audit functions to start having conversations about the work they are doing to decarbonise supply chains as part of the journey to Net Zero and how other ESG issues impact their organisations. We urge company directors to work in partnership and collaborate with their internal audit functions to ensure they are fully equipped to deal with the challenges brought about by ESG-related supply chain risks.

To produce this piece, we held meetings with internal audit professionals from industries that are heavily reliant on global supply chains. We held a roundtable in September 2023 with Chief Audit Executives (CAEs), audit committee chairs, and professionals with a background in ESG risk, supply chain risk and internal audit. We also held several one-to-one interviews to gain further insights on this topic. The quotes used throughout this guide are taken from those meetings and other discussions about supply chain due diligence and ESG.

Anne Kiem OBE
Chief Executive, Chartered Institute of Internal Auditors

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Introduction

Within the intricate web of global supply chains, we encounter a multitude of risks - reputational, legal and compliance, environmental sustainability, and climate change - all deeply intertwined with business continuity, and all magnified by the pandemic and global conflicts. These elements create a dynamic landscape where supply chain related ESG risks have the potential to impact organisations on multiple fronts.

It's no longer sufficient for organisations to merely optimise their supply chain operations; they must do so with a keen awareness of their environmental footprint, social responsibility, and ethical governance. To navigate this complex terrain, internal audit can provide insights, guidance, and assurance across three themes: Environmental sustainability, social and governance responsibility, and the effectiveness of ESG risk management programs. Internal audit can support ESG efforts by providing assurance to the board and senior management in identifying, managing, and mitigating ESG-related supply chain risks effectively.

Organisations are under increasing pressure to ensure that their suppliers adhere to labour rights and legislative standards, reduce their carbon footprint to support the road to Net Zero, and eradicate any human rights abuses throughout their supply chain. However, violations of labour rights, such as forced labour, child labour, and modern slavery can be difficult to detect and prevent, particularly in complicated global supply chains, potentially exposing businesses to reputational harm and legal action. The lack of transparency in the supply chain, where numerous suppliers may withhold key information or offer incomplete or misleading data, can make it difficult for supply chain teams to analyse and mitigate ESG risks in their supply chain.

Climate change risks are becoming an increasingly prominent issue for businesses as they seek to reduce their carbon footprint within their supply chain and operate in a more socially responsible manner. Natural disasters exacerbated by accelerating climate change such as hurricanes, floods, and wildfires can also cause major disruption to the supply chain operations by damaging infrastructure, disrupting transportation networks, or causing power outages. Climate change-related risks such as extreme weather events and rising sea levels can also have significant impacts on supply chains, particularly for industries such as agriculture, forestry, and manufacturing.

In addition to physical risks, transition risks can also have a significant impact on an organisation and are often triggered by changes in legislation, technology, and consumer behaviour. For example, car companies have invested heavily in Electric Vehicle (EV) technologies to reduce the carbon emissions of their vehicles. The EV batteries market is still developing and there is the supply chain risk around shortages of critical materials such as lithium and cobalt used in these batteries. This could lead to production delays for organisations and higher prices for EVs for consumers. In some cases, organisations have faced risks such as higher costs and lower profits in the short term during this transition.

Environmental sustainability is increasingly important to businesses from a reputational perspective. Customers are demanding more environmentally sustainable goods and services. Companies that are thought to be contributing to environmental damage, risk bad press and reputational harm. Tesla, an electric car company, has been criticised for its environmental impact.

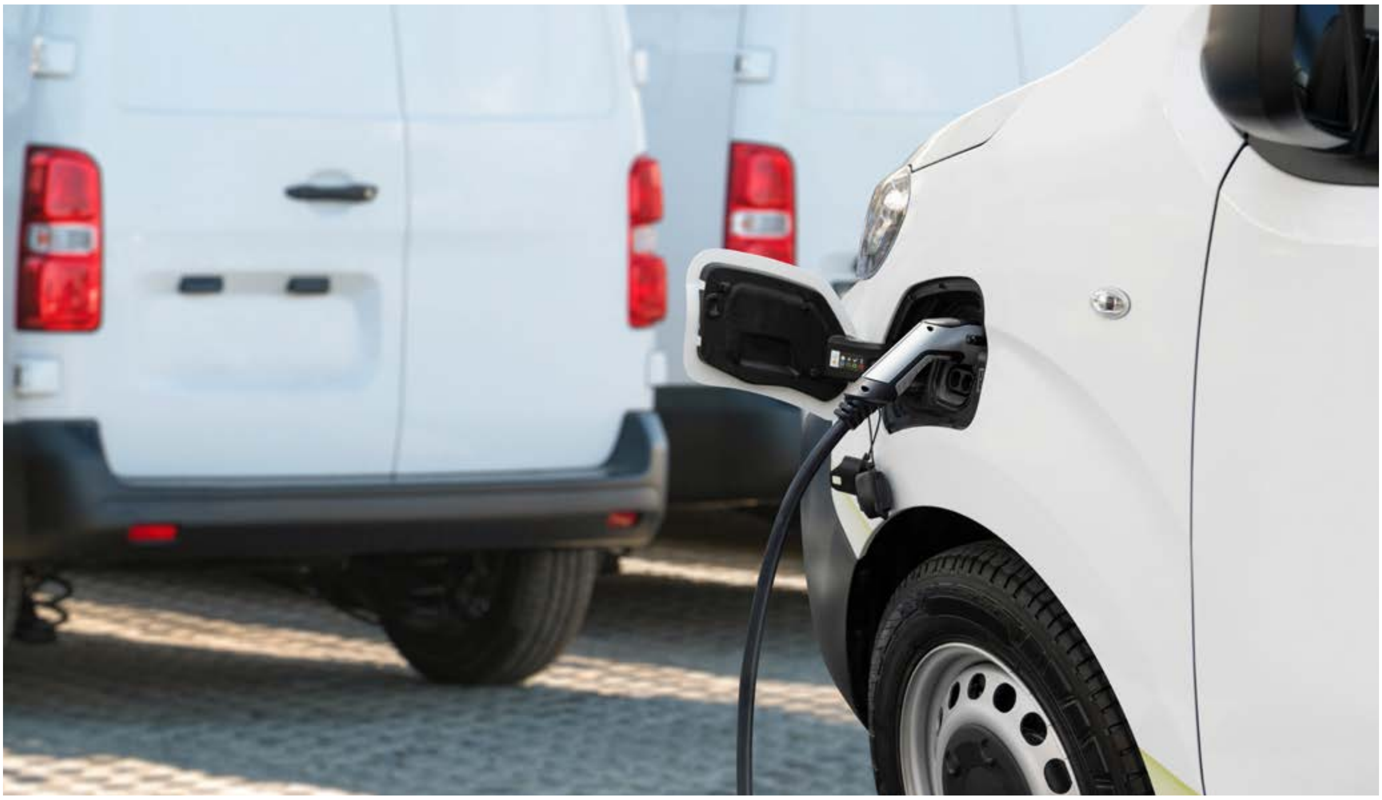
The company has been accused of using child labour within its supply chain to mine cobalt, a key material in its batteries. Tesla has also been criticised for its lithium mining operations, which can have a negative impact on groundwater and ecosystems[1]. Amazon, the world's largest online retailer, has been accused of generating a large amount of packaging waste and of having a high carbon footprint throughout its supply chain[2]. Nestlé, a Swiss food and drink company, has been accused of using excessive amounts of water[3] and contributing to deforestation through its 3rd party supply chain partners[4].

Supply chains may also be impacted by legislative changes and environmental sustainability policies. For example, 'The German Supply Chain Act' is a piece of legislation that mandates businesses to undertake due diligence on their supply chains and make efforts to prevent human rights breaches and environmental issues.

Although this issue is gaining prominence, supply chain expertise is itself in short supply in both organisations and internal audit functions.

Our latest Risk in Focus 2024 report highlighted that the amount of time internal auditors spend on supply chain-related issues is expected to drop to 9th place by 2027[5]. In fact, the internal auditors we spoke to during our roundtables and one-to-one interviews spend on average less than 5% of their time yearly on supply chain risks. This disconnect is worrying as the risk profile is changing and the overall risk posed by supply chain-related risk is increasing, but the time spent by internal auditors on this risk is trending in the other direction. However, for some internal audit functions, the in-house skills to assess these supply chain risks may not be adequate or available at all.

In this report, we will explore how ESG considerations influence an organisation's supply chain operations and internal audit's role in measuring the effectiveness of ESG due diligence and risk management practices carried out by their organisation.



[1]Apple and Google named in US lawsuit over Congolese child cobalt mining deaths, The Guardian.
[2]Amazon's annual plastic packaging waste could circle the world 800 times, report alleges, Euronews.
[3]Drought-hit California moves to halt Nestlé from taking millions of gallons of water, The Guardian.
[4]Pepsico, Unilever and Nestlé accused of complicity in illegal rainforest destruction, The Guardian: .
[5]Risk in Focus 2024, Chartered IIA.

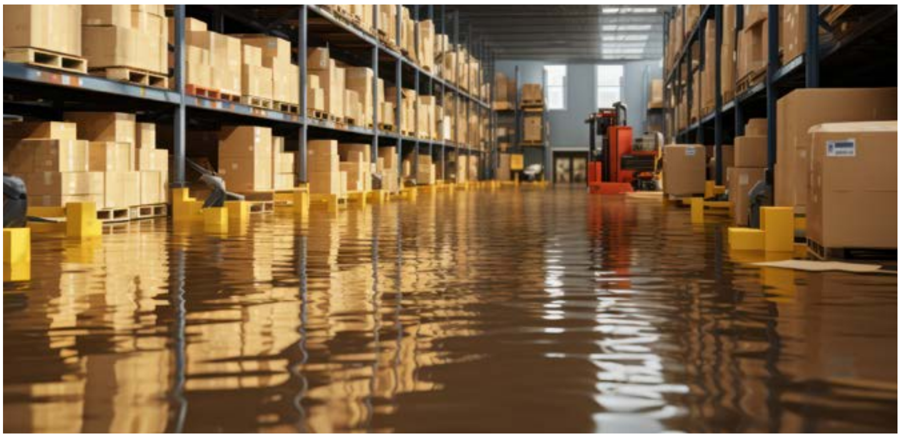
Environmental sustainability considerations in supply chain management

Environmental issues can have a profound impact on an organisation's supply chain, with wide-reaching consequences for its sustainability and operational resilience. The Covid-19 pandemic exposed vulnerabilities in supply chains worldwide. The supply chain landscape is not immune to the disruptive effects of climate-related extreme weather events and evolving ESG legislation. The 2021 UK climate risk assessment commissioned by the Climate Change Committee highlighted that "*Extreme events are already a significant cause of supply chain disruption across all sectors with exposure to climate hazards set to increase in the future*[6]." These climate-related disasters and new legislation to counteract these events will shape the way organisations approach environmental issues in their supply chains.

As globalisation creates an even greater complexity and extends supply chains, the risk of these environmental concerns having an impact on an organisation's supply chain grows. The increased likelihood of these risks materialising is apparent, and action is required by internal audit and organisations. Organisations now more than ever need to show due diligence when assessing suppliers to ensure that they are practising environmental sustainability and have appropriate contingency plans in place for when a climate change-related event occurs.

Extreme weather events have had a significant impact as of late, affecting the availability of goods due to disruptions in transportation and manufacturing. Floods in Germany and Belgium in 2021 disrupted the transportation of goods, blocking roads and rail links, resulting in a major impact on supply chains in both countries[7]. Extreme weather swings in North Africa and Southern Europe have led to a shortage of tomatoes and other fruit and vegetable imports for the UK[8]. Wildfires in the Mediterranean damaged crops and vineyards whilst also disrupting the transportation of goods in Greece and Italy[9].

When supply chains are operating effectively, there is a natural temptation to put more emphasis on increasing efficiency and profitability and less on worrying about what will happen if something goes wrong. There is also the reality that if an organisation is under stress, it looks to cut costs and the focus on ESG often comes a distant second to a cheaper price. Internal audit may need to test the organisation's consistency of focus against its financial and ESG risk appetite. Lessons were learnt during the Covid-19 pandemic and now the ensuing crises of geopolitical conflict, environmental disasters, and economic woes have altered the mindset of organisations.



These events underline the need for organisations to consider the risks associated with their supply chain. The global supply chain landscape is fraught with complexity, and challenges often emerge from unforeseen events. Although climate-related disasters are ultimately unpredictable, the impacts of climate change have led to an increase in the frequency and severity of these disasters.

[6] UK Climate Risk Independent Assessment – UK Climate Risk -Climate Change Committee - 16 June 2021.
[7] CNBC, Global shipping industry disrupted again, this time by floods in Europe and China.
[8] Tomato shortage hits supermarkets after poor weather across Europe and Africa, The Retail Bulletin.
[9] Record Temperatures, Wildfires Wreak Havoc on Europe's Winemakers, Bloomberg.

And as global temperatures continue to rise, it is increasingly likely that it is going to be a constant for the foreseeable future.

Internal audit can work with risk management in the 2nd line to assess the effectiveness of any business continuity and crisis management plans. This is to stress test the organisation's ability to cope with supply chain disruption caused by these climate-related extreme weather events.

Reducing the carbon footprint and increasing environmental sustainability has now evolved into a non-negotiable aspect of modern-day supply chain management, and even more so with the appearance of specific supply chain regulations. **For organisations operating in the UK and Europe, there are several environmental regulations that must be followed within their supply chains. Some of the most important regulations include:**

- **EU Timber Regulation**
This regulation prohibits the import and sale of illegally harvested timber and timber products into the EU.

- **The Waste (England and Wales) Regulations 2011**
These regulations set out rules for the collection, transport, recovery, and disposal of waste in England and Wales. They also establish a hierarchy of waste management options, with prevention being the most preferred option and disposal being the least preferred option.

- **The Packaging (Essential Requirements) Regulations 2015**
These regulations set targets for the reduction of packaging waste and promote the use of recyclable packaging materials in the UK.

- **The Eco-design for Energy-Related Products and Energy Information Regulations 2021 (UK)**
This directive sets energy efficiency standards for a range of products, including appliances, lighting, and electronic equipment.

- **German Supply Chain Act**
This law requires large companies with more than 3,000 employees to identify and assess the risks of human rights abuses and environmental damage in their supply chains. Companies must also take steps to mitigate these risks and report on their progress annually. A proposal for a European-wide version of this act called the 'Corporate sustainability due diligence directive (CS3D)' has now been tabled by the European Commission.

- **Critical Raw Materials Act**
This proposed legislation aims to secure the EU's supply of critical raw materials by identifying and mapping critical raw materials, promoting sustainable sourcing, diversifying supply chains, and supporting research and innovation.

- **Corporate Sustainability Reporting Directive (CSRD)**
This new EU law requires all large companies and listed SMEs to publish regular reports on their environmental and social impact activities Companies will need to report on a wide range of sustainability issues, social and employee matters, respect for human rights, anti-corruption and bribery issues, and diversity concerning gender and other aspects such as age, or educational and professional backgrounds in their board of directors.

These regulations are designed to protect the environment and ensure that supply chains are sustainable and ethical. After years of ‘greenwashing’ and lip service on environmental initiatives carried out by organisations, their stated activities now must be backed by evidence. Internal audit can help ensure the organisations are complying with these regulations. By working with procurement/supply chain teams, internal audit can provide assurance against the due diligence processes carried out by organisations on potential/existing suppliers. This includes requiring suppliers to sign and comply with a code of conduct that includes environmental standards, implementing a system for monitoring and reporting on supplier performance, and training employees on environmental regulations and compliance procedures. In addition to these domestic regulations, organisations need to ensure that any overseas 2nd and 3rd level suppliers are demonstrating their compliance with their local regulations.

This is not just about regulatory compliance and crisis management; it’s about organisations’ commitment to sustainability. Along with preparing for the risks that climate change may pose to an organisation, there is an opportunity for organisations to reduce their carbon footprint and improve their supply chain sustainability.

Sustainability is increasingly becoming a cornerstone of supply chain management. Not only do organisations need to look at their carbon footprint, but a critical aspect of supply chain sustainability is also evaluating the environmental practices of its suppliers. For example, scrutinising suppliers’ carbon footprint, waste management processes, and responsible use of natural resources.

Furthermore, it involves a comprehensive examination of suppliers’ adherence to environmental regulations and guidelines. However, this is complex as the need for business continuity and profits may clash with these sustainability goals.

In a wider context, countries are increasingly recognising that they need to take action to reduce their greenhouse gas emissions and some countries have set a legally binding target date to be Net Zero. The calculations of Scope 1, 2, and 3 emissions, which categorise an organisation’s greenhouse gas emissions, provide a comprehensive framework for organisations to measure and manage their greenhouse gas emissions, aligning their efforts with national Net Zero targets. The Green House Gas Protocol (GHG) is the standard for GHG accounting and has 3 defining scopes: Scope 1 covers direct emissions, Scope 2 includes indirect emissions from purchased energy, and Scope 3 involves indirect emissions from the organisation’s upstream and downstream activities throughout their supply chain.

Scope 3 includes emissions from raw material extraction, transportation, product and service use, and waste disposal. Scope 3 emissions are often more difficult to measure and manage, as they occur outside of the organisation’s direct control.

“Scope 1 and 2 emissions are easier to manage, and we are auditing this data. Scope 3 emissions, however, that come from the supply chain is a difficult area to deal with”

Director of Group Assurance – Automotive Company

However, Scope 3 emissions can often be the largest source of GHG emissions, so it is important to understand and manage them. Internal audit can assess the quality, accuracy, and reliability of GHG data and evaluate the effectiveness of an organisation's GHG emissions reporting and management processes.

One of the roundtable participants, a CAE of a leading supermarket highlighted the need to balance keeping products on the shelf all year round to meet customer demand for out-of-season goods with the need to source these goods locally and sustainably. Our latest Risk in Focus 2024 report shows that organisations are focusing on their business continuity initiatives to cope with the growing scarcity and expense of key products. Respondents in this year's Risk in Focus survey ranked business continuity, operational resilience, crisis management, and disaster response as the 5th biggest threat[10].

The geographical locations of suppliers are also key to supply chain sustainability and mitigating risks. One benefit of finding local suppliers rather than globally is that an organisation can reduce its scope 3 emissions. The 'think globally, act locally' approach to the supplier section may benefit the organisation and mitigate these Scope 3 emissions but may not always be practical. In addition, working with suppliers in areas vulnerable to environmental risks such as hurricanes, floods, wildfires, and other climatic challenges can disrupt the supply chain, leading to delays and increased costs. Organisations may need to proactively assess these risks and opportunities and develop strategies to diversify their supplier base and fortify their supply chain against climate-related disruptions.

Sustainable sourcing practices are pivotal in mitigating the environmental impact of a supply chain. Organisations should be prioritising sourcing materials and products from suppliers who follow sustainable practices, emphasising eco-friendly alternatives and responsible production methods. Sustainable sourcing fosters a symbiotic relationship between an organisation and its suppliers, with both parties working towards a shared goal of environmental stewardship.

[10]Risk in Focus 2024, Chartered IIA.

Actions for internal audit

Internal auditors can help organisations address these issues. However, a recent study by the IIA Netherlands found that some CAEs are not including topics such as climate impact in their supply chain assignments[11], which represents both a risk and a missed opportunity. As the new laws, regulations, and reporting requirements begin to be enforced, the topic of environmental sustainability also becomes a compliance risk for internal audit.

Internal audit should aim to conduct risk assessments and try to pinpoint environmental risks in the supply chain. Although unpredictable, by monitoring and assessing the potential impact that climate change has on the supply chain, internal audit can aid the preparedness for when disaster strikes and help the organisation respond swiftly and effectively. Here are some examples:

Compliance and Regulation: When working with procurement and supply chain teams it is important to gain an understanding of the regulatory landscape and its implications on supply chain operations. Review the organisation's supplier code of conduct and carry out contract audits to see if these agreements are fit for purpose and evaluate if risk assessments are done at the initial decision-making stage. Evaluate the organisation's compliance with local, national, and international environmental laws. Encourage the monitoring of changes in legislation and ensure that the organisation and any current and potential suppliers remain in adherence to these regulations.

Business Continuity: The need to supply customers year-round comes at a cost. Sourcing globally rather than locally to fulfil this customer need has environmental impacts. Assess whether management has effective business continuity plans in place to cope with supply chain disruption, including disruption caused by climate-related extreme weather events, and whether those scenarios are actively rehearsed and refreshed.

Environmental Risk Assessment and Mitigation Strategies: Internal auditors could conduct risk assessments on the potential impacts of environmental risks, such as extreme weather events or resource scarcity. This is an opportunity to test how resilient the organisation's supply chains are in this area and identify areas of vulnerability and exposure. This is the time to ask questions about the existing processes and measures. Is the appropriate crisis management in place ahead of these climate-related events? Is the responsiveness to this changing risk profile adequate? By identifying and assessing these risks, organisations can develop and implement mitigation strategies.

Auditing and Providing Assurance Against Sustainability Plans: Over-commitment and underachieving on sustainability targets can have the organisation in the firing line of public scrutiny and criticism. Internal audit can challenge the organisation by evaluating these plans and asking questions about how these environmental targets will be delivered. Can the organisation prove that these environmental targets are achievable? Are these initiatives measurable and realistic? Being able to provide auditable evidence to support environmental statements is important. These challenging questions can guide the organisation in improving and achieving its sustainability goals.

Recommendations for Sustainability: Following audits, internal auditors can provide recommendations and insights into improving sustainability practices within the supply chain. These recommendations may include process improvements, initiatives to reduce the organisation's carbon footprint and even recommending changes in supplier sourcing.

Roles and Responsibilities: There needs to be a clear allocation of roles and responsibilities in relation to the supply chain and the risks associated for both management and overseers of risk in the 1st, 2nd, and 3rd lines. An understanding of resource allocation put towards mitigating supply chain risks and clarity on who is responsible for any risk mitigation actions is key when providing assurance on the supply chain.

[11]See IIA Netherlands' 2023 paper Internal audit and supply chain risks.

It is important to understand who is responsible for what in the organisation for internal audit to have a clear understanding of where the pressure points may be. Who is responsible for delivering environmental proposals and targets within the organisation? Who is responsible for the gathering of emission data? Who is responsible for ensuring the implementation and effectiveness of the supplier contracts, policies, and procedures? These are key questions for internal audit when providing an overall assurance against the ESG risks posed to an organisation.

Supplier Risk Management: Internal auditors can assess how well the business understands the supplier's challenges and whether adequate monitoring is in place to detect potential problems early on. Organisations can then make informed decisions regarding supplier selection and risk mitigation strategies. But keep in mind that even if some supplier contracts have ESG KPIs, there is an element of trust in this process, and it is not always possible for the supply chain team to impose its organisation's supply chain standards on their suppliers during negotiations. However, initial and ongoing contracts should be robust enough to prevent this from happening and where standards cannot be met, this must be clearly documented understood and the position accepted or otherwise by the organisation.

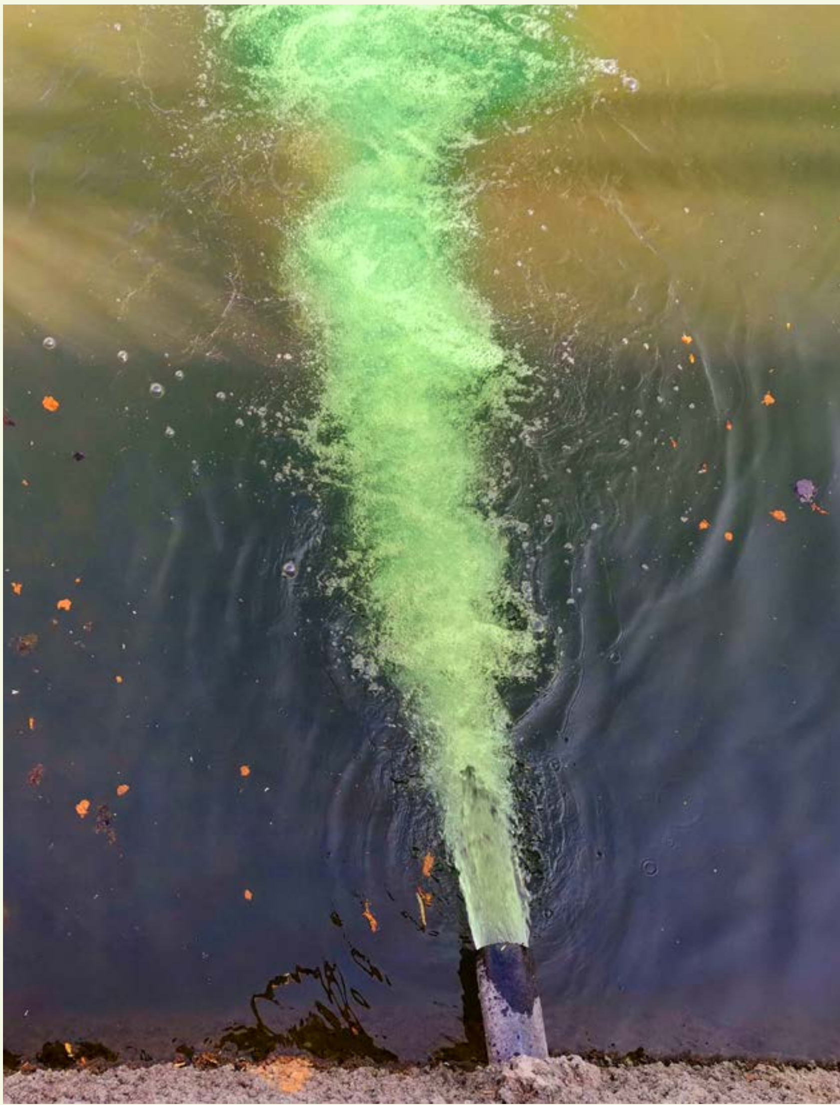
Recent environmental events and legislation have highlighted the importance of these considerations and the need for proactive risk management and supply chain resilience. Boards and chief internal auditors should prioritise these aspects to safeguard their organisations against environmental supply chain disruptions and align with evolving environmental standards. As supply chains continue to evolve, addressing environmental issues will remain imperative to an organisation's reputation and long-term sustainability.

"(our supply chain) Is not driven by ESG as such but more by the need to get products on the shelf. So, we need to look at how resilient our supply chain is, so we can source from different areas and see how quickly we can respond (to climate-related impacts)"

CAE, Major Supermarket

"It's about getting the (ESG) strategy right then getting the actions to deliver this strategy in our supply chain. Once we provide assurance on this, coverage of the necessary processes and controls to monitor delivery will fall into the audit plan in the coming years"

Head of Internal Audit – Construction Company



Social and governance considerations in supply chain management

The modern business landscape is characterised by a growing emphasis on ethical and responsible practices throughout the supply chain. Many organisations are now part of a complex network of interconnected entities spanning across the globe. And with this global network, the spectrum of potential concerns and risks is vast, encompassing human rights violations, labour practices, and corruption, among others. As with environmental issues, organisations are under increasing pressure to ensure that their suppliers adhere to labour rights and standards and eradicate any human rights abuses and corruption throughout their supply chain. However, it can be challenging to identify and stop abuses of workers' rights, including forced exploitation or child labour, especially in complex international supply chains. These violations in human rights could potentially expose organisations to reputational harm and possibly legal action. The lack of transparency in the supply chain, where numerous suppliers may withhold key information or offer incomplete or misleading data, can make it difficult for businesses to analyse and mitigate ESG risks in their supply chain.

Notable examples of social and governance issues within the supply chain include the Rana Plaza factory collapse in Bangladesh in 2013, which revealed dire labour conditions and inadequate safety measures in the garment industry. Several brands, including Walmart, Gap, and H&M, were sourced from the factory at the time of the collapse. The brands agreed to pay $30 million into a compensation fund for the victims and their families. This event resulted in heightened scrutiny of global supply chains and increased pressure on companies to ensure better working conditions for their suppliers' employees[12]. Additionally, the Volkswagen emissions scandal in 2015 highlighted governance issues within the organisation. The company's unethical emissions manipulation practices had far-reaching implications, affecting not only Volkswagen but also its suppliers and the broader automotive industry[13]. In 2020, Online fashion retailer Boohoo pledged to take urgent steps to improve governance and oversight of its supply chain after an independent report found widespread instances of dangerous working conditions and underpayment of staff[14]. However, in 2023 the fast-fashion firm was found to have broken this pledge to make its clothes fairly and ethically, after a BBC Panorama investigation found these unethical practices to still be happening[15]. These scandals have also led to calls for greater transparency and accountability from companies. Investors and consumers want to know how companies are managing their ESG risks and how they are making progress on their ESG goals. Internal audit can help an organisation become more transparent about its ESG goals by evaluating the governance, reporting, and performance in this area.

This need for transparency is also being reflected in the policy and regulatory landscape. The UK has regulations in place to eliminate child labour from supply chains. The 2015 UK Modern Slavery Act requires companies with a turnover of £36 million or more to disclose the steps they are taking to guarantee that slavery and human trafficking do not occur in their supply chains[16]. Furthermore, the UK government has developed initiatives like the Ethical Trading Initiative to encourage businesses to improve labour conditions in their supply chains. In addition, the EU Conflict Minerals regulation requires companies that import certain minerals from conflict zones to take steps to ensure that their supply chains are free of human rights abuses and corruption.

[12] Abuses 'still rife': 10 years on from Bangladesh's Rana Plaza disaster, The Guardian.
[13] Volkswagen: The scandal explained, BBC.
[14] Boohoo has 'significant issues' in its supply chain, review finds, Financial Times.
[15] Fast fashion: Boohoo breaks promises on ethical overhaul, BBC.
[16] Modern Slavery Act 2015, Gov.UK.

Supply chains today stretch across the globe, often touching regions with diverse cultural, social, and political landscapes.

Ensuring that the supply chain adheres to ethical and social responsibility standards is more important than ever. Organisations need to consider preventative measures to protect their supply chains from social and governance issues. Effective due diligence by evaluating suppliers for ethical practices, at the tender stage where possible, can be one way to protect the organisation.

Most organisations have a code of conduct that all suppliers must sign. However, there is a potential risk of suppliers breaking that code of conduct, especially when based overseas away from the eyes of the organisation, leading to the reputation of the organisation being damaged. Corruption and bribery pose significant threats to the integrity of supply chains. The implementation of robust anti-corruption policies, contracts and agreements being transparent, and all financial transactions closely monitored to detect any irregularities is crucial. Addressing corruption in the supply chain requires comprehensive risk assessments and the development of mechanisms to prevent, detect, and respond to corrupt practices. Achieving ethical and responsible supply chain practices requires transparency and disclosure. Social responsibility and governance considerations are irreplaceable pillars of ESG risk management in supply chains. Organisations now have the spotlight on them to disclose their efforts in tackling social and governance issues, allowing stakeholders to make informed decisions about engaging in business with them.

Actions for internal audit

Ethical and socially responsible practices in the supply chain are integral to an organisation's reputation, risk management, and operational success. To ensure such practices are effective, companies must thoroughly evaluate and continually monitor their suppliers for compliance with ethical, social and governance standards. Internal auditors are well-positioned to support organisations in this process by performing audits, assessing risks, providing assurance on monitoring systems, and offering recommendations for improvement. Recent legislation and real-life events have emphasised the significance of these efforts, making them important considerations for boards and chief internal auditors in their risk management and supply chain due diligence strategies. As supply chains continue to evolve and grow more complex, addressing social and governance issues will remain at the forefront of responsible and sustainable business practices.

Here are some ways internal audit can contribute to successful social and governance due diligence and risk management for their supply chains:

Supplier Compliance Audits: Internal auditors may be well-positioned to evaluate supplier compliance with ethical and governance standards. Internal audit can evaluate the organisation's suppliers' code of conduct to see if the due diligence checks of potential suppliers are adequate and align with the organisation's overall strategy. They can work with procurement and supply chain teams to ensure these codes are up to date with any legislative requirements. If necessary, these audits could involve in-depth investigations, including site visits, document reviews, and interviews with key personnel.

Risk Assessments: Internal auditors can perform comprehensive risk assessments related to social and governance issues within the supply chain. By identifying potential vulnerabilities, internal auditors can help organisations develop risk mitigation strategies that specifically address these concerns.

Monitoring Systems: Internal audit functions can collaborate with other departments to provide assurance on the development and implementation of supply chain monitoring systems. These systems are essential for continually assessing supplier adherence to ethical practices and standards. The use of technology and data analytics not only enhances the effectiveness of such monitoring but also increases the quality and reliability of the data gathered. This can help internal audit to evaluate this data with confidence.

Recommendations for Improvement: Based on their findings, internal auditors can provide recommendations for improving supply chain ethics and governance. These recommendations often encompass actions related to supplier management, process improvement, and risk mitigation.

Policy Development and Compliance: Internal auditors can contribute to the development of anti-corruption policies, supplier codes of conduct, and ethical sourcing guidelines. Furthermore, they can ensure that these policies are effectively communicated, understood, and adhered to throughout the organisation and its supplier network.

Build relationships: Internal audit should aim to build relationships with the first and second-line functions to get a stronger understanding of the risk faced by the organisation in the supply chain. Working with risk management teams, procurement teams, supply chain teams etc. so internal audit can provide assurance on the existing processes to mitigate these risks, pinpoint any potential flaws in the organisation's ESG risk approach, and ensure the first and second-line's views are appropriate within its current supply chain operations.

"Internal Auditors tend to be present where we store and sell our products therefore you don't have internal audit presence where the supply chain originates. If you really want to be serious about ESG considerations in your supply chain, you'll tend to need to partner with a third party in the countries where the products come from, and often this is in Asia"

Sustainability VP - Large International Distribution Company

"Internal audit and management should be working with suppliers to ensure that the supply chain reflects the ESG strategy, ambitions and intent of the organisation"

Head of Internal Audit – Construction Company

Measuring the Effectiveness of ESG Risk Management Programs

Measuring the effectiveness of the ESG risk management program is key. Internal audit can be useful in ensuring ESG objectives are met and that responsible business practices are upheld throughout the entire supply chain ecosystem. In recent years, organisations have harnessed innovative methods and technology to enhance their capabilities in evaluating ESG risk management within supply chains. Internal audit can assess not just the existence of these programs but their integration into supply chain strategies. Through this, internal audit can determine if ESG considerations are an integral part of decision-making processes. Recommendations from internal audit can then serve as a catalyst for enhancing these programs, ultimately safeguarding the supply chain against a multitude of risks, from climate change impacts to social and governance issues to natural disasters.

Key Performance Indicators (KPIs) and Metrics in Supply Chain: Internal audit teams can assess the effectiveness of an ESG risk management program by examining KPIs and metrics specific to the supply chain. This includes metrics related to reducing carbon emissions, ensuring ethical sourcing, promoting diversity among suppliers, and improving compliance with labour and human rights standards. By scrutinising these supply chain-focused indicators and the quality of the data collected, internal auditors provide valuable assurance. This includes insight into the performance of the program and its alignment with the company’s ESG objectives and holds the organisation accountable to these targets.

Supply Chain Compliance Audits: Internal auditors can work with ESG and supply chain professionals within their organisations to conduct compliance audits to ensure that the organisation’s supply chain adheres to relevant ESG regulations and standards. This encompasses evaluations of environmental regulations, labour laws, and ethical sourcing guidelines within the supply chain. Innovations in data analytics and artificial intelligence (AI) can enable internal auditors to efficiently analyse large datasets, aiding in the identification of compliance gaps and areas necessitating improvement.

Risk Assessments with a Supply Chain Lens: Internal Auditors can utilise advanced risk assessment tools and methodologies to evaluate ESG risks specifically within the supply chain. They can work with other teams to take part in scenario-based simulations to identify emerging risks, their potential impacts on the supply chain, and the associated risks of supplier misconduct or environmental incidents. Technology-driven risk modelling and simulation tools aid organisations in predicting and measuring the financial and reputational consequences of ESG risks within the supply chain.

Supply Chain Data Analytics: Advanced data analytics tools can allow internal audit teams to examine large datasets for anomalies, trends, and patterns that are exclusive to supply chain operations. By analysing data related to supplier performance, environmental impact, and labour practices, internal auditors can identify areas where the supply chain excels and areas that require attention. Data analytics also help in the early detection of supply chain related ESG issues.

Supplier Audits and Evaluations: Internal audit can conduct thorough supplier audits and evaluations to ensure that suppliers adhere to ESG standards. Advanced audit techniques, including on-site inspections and digital supply chain tracking can help internal auditors verify supplier compliance with ESG requirements.

Telematics & Blockchain for Transparent Supply Chains: By leveraging innovative methods like telematics & blockchain technology, internal audit can enhance transparency and traceability within the supply chain. Telematics providing real-time data on the asset location, conditions, route etc helps not only with product tracking but with transparency in the supply chain. In addition, by recording ESG-related transactions and certifications on a tamper-proof blockchain, internal auditors can verify the authenticity of supplier claims and ensure that the supply chain meets the required ESG standards.

AI Machine Learning for Predictive Supply Chain Analysis: Machine learning algorithms can be applied to predict future ESG risks within the supply chain by analysing historical data and trends. These predictive models could help internal auditors identify potential hotspots and areas that require ESG risk mitigation measures. However, considerations should be made regarding internal audit's capability to deploy AI, as a particular skill set is required to utilise the power of AI effectively.

Cybersecurity and Data Protection in the Supply Chain: Given the digital nature of supply chain data, internal audit can also evaluate the cybersecurity and data protection measures in place to safeguard ESG data within the supply chain. Innovations in cybersecurity technology can assist internal auditors when assessing the robustness of the security of the supply chain data, protecting it from breaches and unauthorised access.

Internal audit can play an important role in measuring the effectiveness of ESG risk management programs. Leveraging innovative methods and technologies, internal auditors could provide valuable insights that contribute to responsible and sustainable practices throughout the supply chain ecosystem. As ESG considerations continue to be a critical aspect of business operations, internal audit's ability to adapt to new technologies and methodologies is fundamental to ensuring effective ESG risk management and accountability within the supply chain.

Conclusion

Environmental sustainability and social responsibility are no longer optional; they are imperative. As supply chains grow ever more complex, stakeholders, including shareholders, investors, and the public, are increasingly demanding that organisations take their environmental and social responsibilities more seriously.

As organisations intensify their commitment to ESG values and goals, internal auditors must be well-prepared when navigating the complexities and challenges that come along with this and how it impacts the supply chain. A collaboration between internal audit professionals, boards, ESG experts, risk management, supply chain, and procurement teams is essential.

Internal audit should evaluate the existing processes and procedures within its supply chain to see if they adequately consider the evolving risk landscape associated with climate change. As organisations devise Net Zero commitments, internal audit needs to provide assurance on scopes 1, 2 and 3 emissions data whilst holding their organisation to account against their environmental commitments.

Additionally, internal audit's involvement in evaluating suppliers for ethical practices, reviewing supplier codes of conduct, and conducting site visits and contract audits allows an organisation to stay on top of these risks. By leveraging innovative methods such as data analytics, AI and other technology, internal audit can enhance its capabilities in evaluating ESG risk management within supply chains and safeguarding the organisation against a multitude of supply chain related risks.

The recommendations and insights presented in this report not only equip internal auditors but also highlight the role they could play in helping their organisations embrace a more sustainable, ethical, and socially responsible supply chain. There is now a need for internal auditors to develop a plan to improve their skills and capabilities when it comes to ESG supply chain risks if they don't already exist.

While the road ahead may present challenges, it is a path where internal audit could be a guiding voice in creating a more socially responsible, sustainable, and resilient future for the supply chain. The demand for environmental and social responsibility is not a passing trend, and internal audit is poised to be a key part of this transformation.

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