# INTERNAL AUDIT'S ROLE IN ESG REPORTING

## Independent assurance is critical to effective sustainability reporting

The Institute of Internal Auditors | Global

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# PURPOSE

## Internal audit's role in ESG reporting

**Conversations and focus on sustainability,** typically grouped into environmental, social and governance (ESG) issues, are quickly evolving — from activist investor groups and inquisitive regulators pushing for change to governing bodies and C-suite executives struggling to understand and embrace the concept. At the forefront of this new risk area is pressure for organizations to make public commitments to sustainability and provide routine updates to ESG-related strategies, goals, and metrics that are accurate and relevant. However, ESG reporting is still immature, and there is not a lot of definitive guidance for organizations in this space. For example, there is no single standard for what should be reported.

What is clear is that strong governance over ESG — as with effective governance overall — requires alignment among the principal players as outlined in The IIA Three Lines Model. As with any risk area, internal audit should be well-positioned to support the governing body and management with objective assurance, insights, and advice on ESG matters.

The following provides an overview of risks related to ESG reporting along with context on the growing sustainability movement. It also outlines internal audit's role in ESG reporting and how internal audit can support ESG objectives and add value.

# INTRODUCTION

## Embarking on the ESG journey

**Efforts to mitigate the accelerating effects** of climate change and address perceived historical social inequities are two powerful issues driving change globally. These movements have enhanced awareness of how all organizations impact, influence, and interact with society and the environment.

They also have spurred organizations to better recognize and manage ESG risks (i.e., risks associated with how organizations operate in respect to their impact on the world around them). This broad risk category includes areas that are dynamic and often driven by factors that can be difficult to measure objectively, such as inclusion, ethical behavior, corporate culture, and embracing sustainability across the organization.

Still, there is growing urgency for organizations to understand and manage ESG risks, particularly as investors and regulators focus on organizations producing high-quality reporting on sustainability efforts. What's more, that pressure is being reflected increasingly in executive performance as more organizations tie incentive compensation metrics to ESG goals.

Additional risk areas associated with ESG are varied and can include reliance on third-party data, potential reputational damage from faulty reporting, and the real possibility that an organization's explicit commitments to meet specific sustainability goals could grow into a material weakness.

As ESG reporting becomes increasingly common, it should be treated with the same care as financial reporting. Organizations need to recognize that ESG reporting must be built on a strategically crafted system of internal controls and accurately reflect how an organization's ESG efforts relate to each other, the organization's finances, and value creation.

Internal audit can and should play a significant role in an organization's ESG journey. It can add value in an advisory capacity by helping to identify and establish a functional ESG control environment. It also can offer critical assurance support by providing an independent and objective review of the effectiveness of ESG risk assessments, responses, and controls. Additionally, internal audit functions that operate in conformance with The IIA's globally recognized standards are well-positioned to help their organizations apply established, credible internal control frameworks to their ESG efforts.

Seeking out objective assurance on all ESG-related risk management processes from a qualified, independent, and properly resourced internal audit function should be part of any ESG strategy. While this white paper outlines how and why internal audit should play a critical role in an organization's sustainability reporting efforts, it bears repeating that reporting comprises only part of an effective ESG strategy. Internal audit should provide assurance and advice over all aspects of ESG risk management.

# KEY CONSIDERATIONS

Building an ESG strategy

## Sound governance, control paramount

**The various drivers of** increased sustainability reporting — investor, regulatory, and social — have created pressure for organizations to produce. However, without a reasoned ESG risk-management strategy built on a clear-eyed understanding of the issues, poorly executed sustainability reports can quickly run afoul of regulatory compliance and astray of investor expectations. To avoid such missteps, leadership should focus on effective internal control and governance over ESG matters.

Each organization ultimately must identify and evaluate its top ESG impacts and determine goals to manage them. Target goals should be realistic and measurable because of the risk of not meeting them.

## Internal control

Internal control is a process, effected by an entity's governing body, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.[1] Because ESG reporting can contain a wide variety of metrics, organizations must establish policies, processes, and internal controls that generate reliable information for decision-making and ensure the quality of data being produced and reported. Similar to financial reporting, the data used to create sustainability reports are based on the day-to-day operations and decisions driving organizations toward achieving objectives. Proper control activities must be designed and operating effectively — from the operational steps to the collection and analysis of the data that will be used in reporting. Operationalizing sufficient control activities is the responsibility of management, while internal audit is responsible for providing independent assurance that the activities are properly designed and operating effectively.

### What is ESG?

**Environmental, social, and governance (ESG) refers to criteria that characterize an organization's operations as sustainable, responsible, or ethical. Although there can be some overlap, ESG-related topics generally fall under one of the three main categories represented in its acronym:**

**E: "Environmental" considers how an organization performs as a steward of nature. This can include issues related to carbon emissions, waste management, water management, raw material sourcing, and climate change vulnerability.**

**S: "Social" examines how organizations manage relationships with employees, customers, and the greater community. Risks that fall under this category can include corporate social responsibility, labor management, data privacy, general security, and health and safety. With the recent rise of high-profile movements related to addressing racial injustice, social ESG-related subjects such as diversity, equity, and inclusion have taken prominence.**

**G: "Governance" refers to variables such as business ethics, leadership, executive pay, audits, internal controls, intellectual property protection, and shareholder rights. Diversity risks, while social in nature, also can fall under the governance umbrella, such as actions to improve board diversity.**

## Governance

In conjunction with strong internal control, organizations should have in place a governance structure that effectively executes ESG strategy. More than simply overseeing the accuracy of ESG data, a good governance structure oversees how the overall ESG strategy is implemented enterprisewide. Governance of an organization requires appropriate structures and processes that enable:

- Accountability by a governing body to stakeholders for organizational oversight through integrity, leadership, and transparency.
- Actions (including managing risk) by management to achieve the objectives of the organization through risk-based decision-making and application of resources.
- Assurance and advice by an independent internal audit function to provide clarity and confidence and to promote and facilitate continuous improvement through rigorous inquiry and insightful communication.[2]

ESG initiatives and reporting, as with the creation and protection of organizational value overall, requires the governing body, management, and internal audit to work collectively to align with each other and the prioritized interests of stakeholders. Alignment of activities is achieved through communication, cooperation, and collaboration. This ensures the reliability, coherence, and transparency of information needed for risk-based decision making.

In the context of governance, it is vital for organizations to consider roles in ESG reporting and risk management. The IIA's Three Lines Model provides a foundation on which to assign such roles. The full board may take on oversight of sustainability or delegate to a subcommittee. The audit committee may be best positioned for such delegation, as it is typically the most experienced in external reporting and understands the importance of policies, procedures, and internal control. Executive management should assume responsibility for planning and executing ESG risk strategies; creating related policies, procedures, and internal controls; identifying relevant metrics on which to base sustainability reports; and overseeing creation of those reports. It also should be keen on understanding and staying abreast of all ESG-related compliance risks. Internal audit should take on the critical role of providing objective assurance, independent from management, over the effectiveness of ESG risk management, reporting, and related regulatory compliance.

The challenges and complexity of ESG reporting are abundantly evident, and the risks associated with poorly managed reporting can be high in terms of regulatory compliance and reputational damage. Therefore, governing bodies and executive management should carefully consider all disclosures and how related assurance responsibilities are assigned.

# INTERNAL AUDIT'S ROLE IN ESG REPORTING

Adding value through assurance and advice

## Reporting accuracy, consistency is critical

**Independent, objective assurance** and advice is fundamental to the role and mission of internal auditing, which makes its involvement in ESG reporting critical. Indeed, the definition of internal auditing in The IIA's *International Professional Practices Framework* (IPPF) describes how it adds value by, ". . . bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

As risks associated with ESG become more evident and prevalent in decision-making by the governing body and executive management, directors must have reliable assurance on the effectiveness of ESG risk management, including ESG reporting. That assurance should come from internal audit.

## Assurance

Assurance over ESG reporting should include at minimum the following components, which a properly funded, qualified, and independent internal audit function can provide:

- **Review reporting metrics for relevancy, accuracy, timeliness, and consistency**. It is critical that all public sustainability reports provide information that accurately depicts an organization's ESG efforts. Internal audit can provide assurance on whether data (quantitative and qualitative) being reported is accurate, relevant, complete, and timely. This is particularly important as regulatory oversight increases.
- **Review reporting for consistency with formal financial disclosure filings.** While sustainability reporting provides nonfinancial data, any information that conflicts with formal financial disclosures will raise a red flag with regulators and investors.
- **Conduct materiality or risk assessments on ESG reporting.** This area can be potentially problematic because organizations sometimes struggle with understanding and reporting what is "material." The International Auditing Standards Board defines materiality as, *"Misstatements, including omissions, are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements."* The definition leaves much to interpretation and judgement by individual organizations. However, organizations must have a clear understanding on how ongoing sustainability efforts or public commitments to reaching sustainability goals can rise to the level of materiality.

- **Incorporate ESG into audit plans.** ESG and sustainability-related engagements currently make up about 1% of typical internal audit plans, according to data from the *2021 North American Pulse of Internal Audit*. This must change as ESG risks and risk management take on greater significance for organizations.

## Advisory

- **Build an ESG control environment.** Competent internal audit functions are familiar with the building blocks of effective control environments. They can recommend the frameworks (e.g., COSO's *Internal Control – Integrated Framework*) to manage/mitigate ESG risks. Internal audit also can advise on developing specific internal controls over ESG reporting.
- **Recommend reporting metrics.** What to report is a key question in managing ESG reporting risks. Internal audit can provide insights into the kind of data (quantitative and qualitative) that accurately reflect relevant sustainability efforts within the organization.
- **Advise on ESG governance**. Internal audit can provide guidance on ESG governance because of its holistic understanding of risk across the organization. It can use its unique perspective to help identify roles and responsibilities, as well as provide training on internal controls.

# GROWTH IN ESG REPORTING

A booming interest in sustainable reporting

## Standards, regulations, and frameworks

**Investor and public interest** in how both business and government impact society has grown significantly, and organizations are responding with increasingly sophisticated measurements of that impact. The resulting reporting supports important decision-making by not only investors and taxpayers, but also by executive leadership and governing bodies.

According to, "The Time Has Come: The KPMG Survey of Sustainability Reporting 2020," 80% of companies worldwide now report on sustainability.[3] That rises to 96% among the world's largest 250 companies. North America boasts the highest regional reporting rate at 90%, according to G&A.[4] The percentage of S&P 500 companies issuing sustainability reports has grown from 20% in 2011 to 90% in 2020.[5]

Growing regulatory interest in sustainability has focused on whether what is being reported accurately reflects an organization's sustainability efforts, how those efforts relate to long-term value creation, and how that influences investors. Yet, many organizations still struggle with what should be reported and how. Adding to the muddle is the lack of a single set of standards on which organizations can build their ESG reporting strategies.

G&A's 2020 survey found that 70% of reporting companies rely on frameworks and standards such as those created by the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), and the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD).[6] These frameworks reflect many of the United Nation's Sustainable Development Goals (SDGs), which were adopted by the UN Member States in 2015. The complexity of sustainability issues is reflected in the SDG's 17 major goals and 169 underlying targets.

## Regulatory focus

The 2020 edition of *Carrots & Sticks*, GRI's flagship publication on sustainability reporting, finds Europe is leading the ESG disclosure agenda, "accounting for 245 reporting instruments, while the Asian markets (174) are increasingly active. North America has a low number of reporting provisions (47), a fact that in part reflects the lower number of national jurisdictions in North America." Country comparisons found higher numbers of reporting provisions, including reporting requirements and resources, in the UK, Spain, U.S., Canada, Brazil, Colombia, and China.[7]

Enforcement efforts are growing, as well. For example, in March 2021 the U.S. Securities and Exchange Commission created a 22-member Climate and ESG Task Force to enhance regulatory enforcement on climate and ESG-related disclosures.[8] Meanwhile, the European Commission has requested technical advice

on the elaboration of EU nonfinancial reporting standards (NFR). The latest efforts to enhance the EU's NFR standards, first adopted in 2014 and updated in 2019, reflect European policymakers' ongoing commitment to realizing their collective sustainability goals.[9]

## Frameworks

There are many approaches to sustainability reporting. Each presents unique reasons for consideration. Although distinct, each can complement the others. It is common for companies to align their sustainability reporting with more than one of the previously mentioned frameworks.

Additionally, many companies choose to publicly report their carbon emissions, climate strategy, reduction initiatives, and much more through the CDP Climate Change Questionnaire. CDP is a not-for-profit charity that, ". . . operates a global disclosure system for investors, companies, cities, states, and regions to manage their environmental impacts," according to the group's website. Responses to the CDP questionnaire, which closely aligns to the TCFD, are publicly available.

Still, there remains no single standard on which to base sustainability reporting that organizations, investors, and regulators can turn to. However, there is some hope that such a standard can be created.

In 2020, five global organizations specializing in sustainability and integrated reporting frameworks and standards announced their intention to work toward creating a comprehensive approach to sustainability reporting. According to a joint announcement from CDP, GRI, SASB, the Climate Disclosure Standards Board (CDSB), and the International Integrated Reporting Council (IIRC), the organizations have vowed to work together to:

- Create joint market guidance on how our frameworks and standards can be applied in a complementary and additive way, and
- Develop a joint vision of how these elements could complement generally accepted accounting principles (GAAP) and serve as a natural starting point for progress towards a more coherent, comprehensive corporate reporting system.[10]

Additionally, the World Economic Forum released a paper in 2020 on common metrics and consistent reporting for sustainable value creation, defining 21 core metrics[11]. Based on existing standards, the metrics were published in hopes of hastening convergence among the leading private standard-setters and bringing greater comparability and consistency to the reporting of ESG disclosures.

### Sustainability Reporting Frameworks

**Global Reporting Initiative (GRI) is designed for disclosure on a wide range of ESG issues and topics relevant to stakeholders; companies select disclosure topics based on a stakeholder inclusive materiality analysis.**

**Sustainability Accounting Standards Board (SASB) is more narrowly focused on a selected few disclosures relevant to a company's overall sector and is geared more toward an investor audience. The material topics and disclosures are suggested by SASB for each of the 77 industries.**

**Task Force on Climate-related Financial Disclosures (TCFD) is a more recently introduced reporting framework and is fixed solely on climate-related financial risk. Disclosures adhere to investors, lenders, insurers, and other stakeholders' expectations.**

**International Integrated Reporting Council (IIRC) Integrated Framework <IR> supports development of integrated reports on an organization's strategy, governance, performance and prospects in the context of its external environment, lead to the creation, preservation, or erosion of value over the short, medium, and long term.**

## Investor pressure

A significant driver of interest in sustainability reporting has been growing pressure from asset management firms. BlackRock, the world's largest asset manager, has thrown its sizeable weight behind socially responsible investing. For example, its CEO Larry Fink announced in 2020 that environmental sustainability would be a core goal for BlackRock's future investment decisions.

In March 2021, BlackRock joined 72 other signatories to the Net Zero Asset Managers Initiative, which commits signers to press companies in their portfolios to achieve net zero emissions by 2050 or sooner.[12]

A 2021 preview on proxy season from EY's Center for Board Matters finds, "Investors want boards to help companies adapt their strategies for a future in which prioritizing stakeholders and considering environmental and social impacts will be critical to building resilience and creating long-term value.

"Investors view workforce diversity as a key component in driving innovation and performance. This is of particular importance in a dynamic environment marked by ongoing business model disruption, changing stakeholder demands and accelerating sustainability risks."[13]

The report, posted on the Harvard Law School's Forum on Corporate Governance, surveyed 60 institutional investors representing more than $38 trillion in assets under management. It finds investors rank "integration of material ESG opportunities into strategy," and "diversity of board, management and workforce" among the three biggest drivers of strategic success in the next five years (ranking second and third, respectively). Additionally, "climate risks and natural resource constraints" was the most often cited threat among the three biggest threats to strategic success in the next five years, according to the EY report.[14]

### Leveraging COSO's Internal Control — Integrated Framework for ESG Reporting

**The search for a unified standard for ESG reporting does not have to hamstring an organization's approach to managing ESG risks. The Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) *Internal Control–Integrated Framework (2013)* provides a proven foundation for evaluating systems of internal control.**

**Created in 1992 and revised in 2013, the framework defines internal controls as, "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance of the achievement of objectives."**

**The framework also identifies five components that can be applied to any system of internal control: control environment, risk assessment, control activities, information and communication, and monitoring.**

**Additionally, COSO and the World Business Council for Sustainable Development (WBCSD) published *Applying Enterprise Risk Management to Environmental, Social and Governance-related Risks* in 2018, guidance that is designed to help risk management and sustainability practitioners apply enterprise risk management (ERM) concepts and processes to ESG-related risks.**

This mounting acceleration of ESG-related investor pressure comes less than two years after the powerful CEO Roundtable issued a revised "Statement on the Purpose of a Corporation," which shifted dramatically toward ESG[15]. The new statement, signed by the CEOs of 181 of the world's largest and most influential businesses, changed the purpose from shareholder primacy — that corporations exist principally to serve shareholders — to one that benefits all stakeholders (e.g., customers, employees, suppliers, communities and shareholders).

# CONCLUSION

## ESG imperative, risk relevance growing

**Increasingly, leaders in business and government** are realizing the importance of ESG as an enterprise imperative. Organizational wellbeing is tied not only to financial strategies and metrics, but also to those that reflect environmental, social, and governance aspects. This holistic approach is indispensable to long-term value creation. Therefore, strategic planning, risk management, and all related assurance must incorporate all four dimensions.

One measure of ESG's growth is the changing attitudes about its relevance in the risk universe. *OnRisk 2021*, published by The IIA in September 2020, found sustainability (ESG) was not yet viewed as a significant area of risk for boards, C-suite, and internal audit. Indeed, sustainability was viewed collectively as the *least* relevant of the 11 risks examined in the report.

This is clearly changing.

As social justice movements and climate change transform organizational priorities, investors and regulators have challenged organizations to report publicly on their ESG strategies, commitments, and actions. Through ESG reporting, companies that effectively integrate ESG considerations into their business strategy and risk management practices can communicate how such considerations affect their business and are relevant to their stakeholders.[16]

The ability of organizations to do this depends on the design and effectiveness of internal control around accounting, reporting, and communication of information. Applying the same systematic rigor to measuring, validating, managing, and reporting material sustainability information that is typically applied to financial reporting should lead to greater corporate and investor/stakeholder confidence, organizational value, and capital markets' effectiveness.[17]

And as with financial reporting, the independent and objective assurance only internal audit can provide must be an integral part of that response.

# NOTES


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