Prioritizing Environmental, Social and Governance

Exploring Internal Audit's Role as a Critical Collaborator

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Shannon Roberts Olusegun Ogunnaike Michelle Uwasomba Simon Wong

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Sounding the Alarm

In June 2021, The IIA and the Internal Audit Foundation, in collaboration with EY, conducted a survey to understand how organizations are using their internal audit functions in support of their environmental, social, and governance (ESG) initiatives. The survey was distributed in North America to chief audit executives (CAEs) and directors in the internal audit profession; 102 responses were received. The survey was designed to gather data and answer the following questions:

- Is ESG an internal audit priority?
- How are organizations reporting ESG metrics?
- What are the existing barriers to internal audit's involvement with ESG programs?
- If internal audit is not involved in ESG program advisory and assurance activities, what function is?
- What support and resources does internal audit need to provide ESG coverage?

From climate change to social and political unrest fueled by diversity, equity, and inclusion (DEI) issues, investors and other stakeholders are sounding the ESG alarm. This is partly the result of the COVID-19 pandemic and devastating weather events around the world attributed to climate change. Stakeholders such as boards, employees, and investors want to know how ESG issues impact the organization's long-term strategy, performance, and value creation. Further, while ESG analysis plays an important role in investing, other stakeholders such as consumers are paying more attention to these measures of organizations' performance. For example, consumers would pay more for sustainable products and demand greater transparency on issues ranging from sustainable practices and labor standards to executive compensation and deforestation policies. Because internal audit's mission is to "enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight,"[i] its involvement in ESG is paramount and a natural fit. However, internal audit's contribution to ESG efforts may be influenced and dependent on the organization's ambition, strategy, programs, and reporting in ESG.

In addition to stakeholder demands, the shift toward a greater focus on ESG is also being fueled by impending regulations. According to EY,[ii] there are three important dynamics to watch on global climate disclosure standards:

- There is growing consensus on the need for a baseline climate disclosure standard.
- Disclosures are just one piece of the broader policy approach to mitigating climate change.
- Despite the uncertainty over future disclosure requirements, the direction is clear that it is time for organizations to build institutional capacity.

At the 26th United Nations (UN) Climate Change Conference (COP26) held in November 2021, the International Financial Reporting Standards Foundation (IFRS) announced the development of the

International Sustainability Standards Board (ISSB), which will set recommendations for ESG reporting designed for an investor audience. It will focus first on climate change disclosures, followed by broader ESG issues. This announcement is significant in that it identifies potential convergence of existing standards for future reporting. The Value Reporting Foundation (VRF), which includes the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC), announced its intention to merge into the ISSB. The Climate Disclosure Standards Board (CDSB) announced its intention to merge some of its standard-setting intellectual property into the ISSB, while the CDP will remain separate.

In addition, the U.S. Securities and Exchange Commission (SEC) has been signaling it is on the path toward regulated climate and ESG disclosures. On 4 March 2021, it created a Climate and ESG Task Force in the Division of Enforcement to develop initiatives to proactively identify ESG-related misconduct. On 22 September 2021, it shared publicly some example letters it is issuing to organizations regarding climate change disclosures based on 2010 Climate Change Guidance. Organizations should have their internal auditors stay current on these market-driven and regulatory developments.

Assurance

While ESG-related issues are considered to be material risks to businesses, only 51 percent of organizations that are reporting on ESG obtain some level of assurance.[iii] According to IIA Standard 2120 – Risk Management, "The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes." Further, IIA Standard 2130 – Control states, "The internal audit activity must assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement." Standards 2120 and 2130 clearly establish a foundation for internal audit's role in providing assurance over the organization's ESG reporting processes and controls.

In addition, The IIA's Internal Audit Competency Framework© specifies competencies required to identify and address the risks specific to the industry and environment in which the organization operates, including competencies related to the social, corporate responsibility, and sustainability knowledge area:

- At the general awareness level, internal auditors are able to describe corporate social responsibility and sustainability.
- Internal auditors at the applied knowledge level examine the organization's approach to social responsibility.
- Internal auditors at the expert level recommend actions to improve the organization's approach to social responsibility and sustainability.

Given Standards 2120 and 2130 and the Framework, internal auditors need to increase support in the near future. The Internal Audit Foundation and EY share these survey findings to help prepare internal audit to become more of a trusted business advisor in ESG.

Organization and Internal Audit Involvement

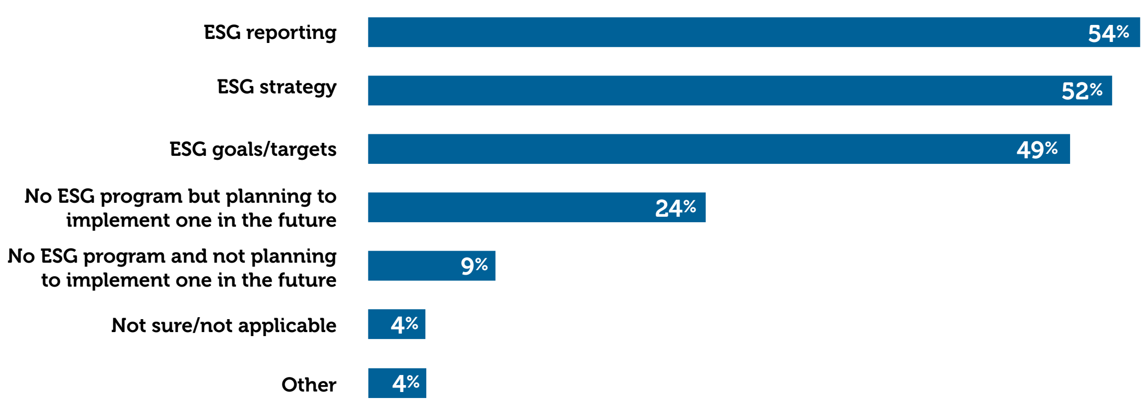
The survey focused on how organizations are involving their internal audit function in enabling it to support ESG performance. Survey responses demonstrate that while most organizations have ESG programs and reporting, many are not yet involving their internal audit function's support in a meaningful way and need to take action soon.

Is ESG a priority in many organizations?

Requirements around ESG are being driven by the tone at the top – 62 percent of CAEs indicate that the board of directors or equivalent is driving the organization's focus and integration of ESG strategy and reporting efforts.

Likely as a result of stakeholder expectations, about two-thirds of organizations already have ESG programs in place. Twenty-four percent have no ESG program but plan to implement one in the future, and just nine percent have no program in place and are not planning to implement one in the future. Among organizations with ESG programs in place, about half are focusing on enhanced ESG strategy, goals and targets, and reporting. (See Figure 1.)

Figure 1: Components of ESG Program

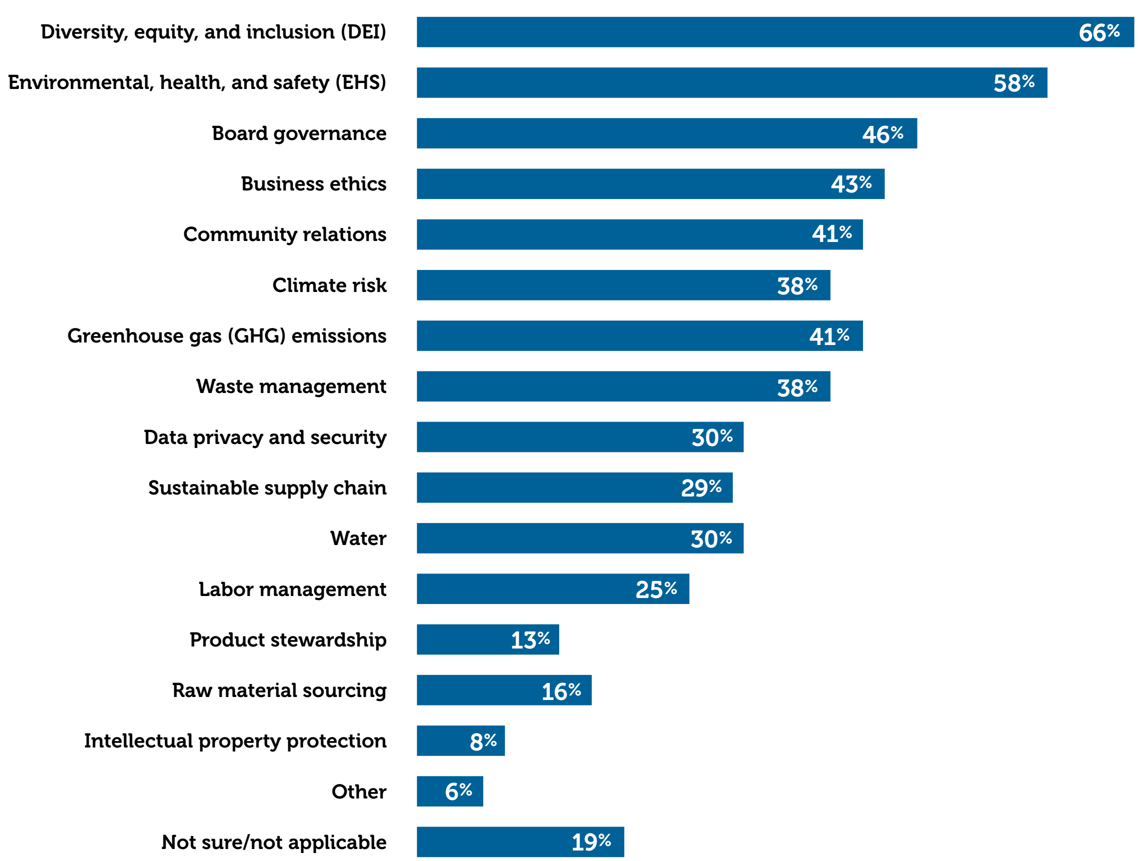


Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: Which of the following elements are components of your organization's Environmental, Social, and Governance (ESG) program? Choose all that apply. *n*=102.

According to Shannon Roberts, EY Principal, Climate Change and Sustainability Services (CCaSS) Ernst & Young LLP, "It is clear there is both a market driven and soon to be likely regulatory driven need for organizations to effectively manage ESG as part of corporate strategy and risk management. Data supports that effective ESG management is now a critical part of an organization's strategy to deliver long-term value for its stakeholders."

A closer look suggests that organizations with ESG programs are focusing on varying topics or issues. Most organizations include diversity, equity, and inclusion (DEI) and environmental, health, and safety (EHS) in their ESG programs. Nearly half include board governance and business ethics components, but just 38 percent of ESG programs address climate risk. (See Figure 2.) This is surprisingly low to Anne Munaretto, EY Senior Manager, CCaSS. According to Munaretto, "Out of everything ESG, climate risk is among those that most influence investors (typically alongside human capital and data security)." However, she also acknowledges that climate risk is still somewhat new to many organizations that have yet to embed resilience into their strategies.

Figure 2: Areas Included in ESG Program



Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: Please indicate which components are included in your organization's ESG program. Choose all that apply. *n*=102.

Senior Manager Simon Wong, Ernst & Young LLP adds:

"In one regard, it is understandable that the majority of respondents indicate that their ESG programs do not address climate risk. The Sustainability Accounting Standards Board's (SASB's) Materiality Map®[iv] considers physical risks of climate change as likely to be material to less than half of reported sectors, and this is consistent with our experience working with organizations on their enterprise risk management."

"However, the challenges posed by climate change extend beyond physical risks, and we are seeing more organizations begin to consider climate-related transition risks in their ESG risk programs, as governmental policies, technological developments, and changes in market sentiment all shift towards a lower-carbon economy. We would expect to see that percentage rise significantly within the next year."

Most organizations have involved their internal audit functions in some way with the organization's ESG initiatives. Just under 30 percent of CAEs of internal audit functions that are involved indicate they are engaged in one or more of the following:

- Providing advice on setting ESG program goals and metrics.
- Reviewing how ESG goals and metrics are tracked and monitored.
- Reviewing implementation of the ESG program and related policy documents.
- Reviewing the accuracy of ESG reports provided to stakeholders.

According to Munaretto, internal audit is most often involved in assurance services supporting processes, controls, and data validation for reported material ESG information. Typical advisory services include weighing in on climate risk and the inclusion of ESG in the organization's enterprise risk management

(ERM) program. Internal audit functions also perform governance engagements to assess whether adequate roles, responsibilities, and processes are in place to execute on the ESG strategy and manage risk. Roberts agrees and adds that internal audit also can provide ESG-focused audits on topics such as climate, environmental compliance and performance, worker safety, data security, and sustainable supply chain practices. Additionally, 10 percent of CAEs indicate that their internal audit function is involved in other ways as well.

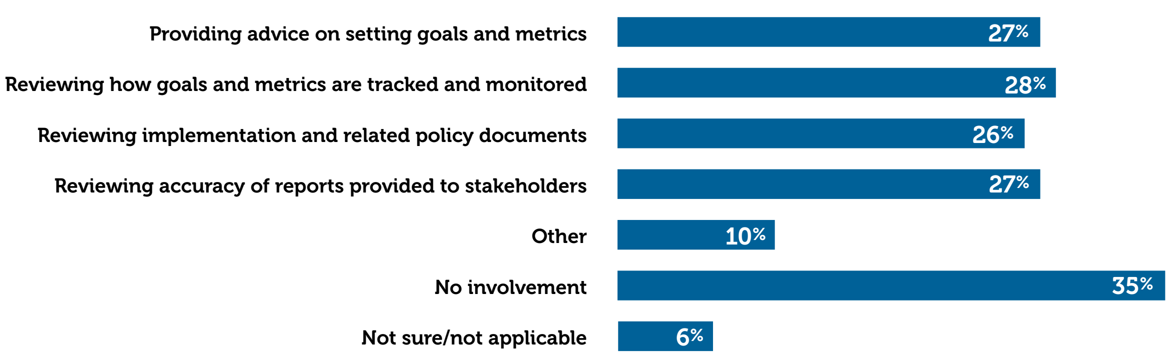
Wong notes, "One area we have seen internal audit add significant value to ESG reporting is assessing the completeness of the operational boundaries, especially for large, decentralized organizations. For example, inventorying the greenhouse gas emissions sources across Scope 1, 2, and 3 emissions requires a deep understanding of the company's operations. Internal audit can provide this insight to validate that all applicable business activities, locations, subsidiaries, and joint ventures are included in reporting."

However, 35 percent of CAEs indicate that their internal audit functions have no involvement (see Figure 3). What other functions might be providing ESG advisory and assurance services?

According to Wong, "At some organizations, the sustainability function has a dedicated team which is solely focused on the accuracy of ESG data and reporting. Finance and controllership play an increasing role in ESG, particularly as it relates to establishing governance and internal controls. Other functions commonly involved include investor relations, legal, and ERM."

"However," notes Wong, "in organizations which are mature in their ESG journey, it is common for internal audit and internal controls functions to be involved in providing assurance over ESG data and controls. Their involvement increases the level of confidence from all stakeholders in the organization's ESG reporting, as well as the organization's preparedness to obtain external assurance from an independent assurance provider."

Figure 3: Internal Audit Involvement



Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: How is internal audit involved in your organization's ESG program? Choose all that apply. *n*=102.

What are the barriers to internal audit's involvement?

Just under 30 percent of CAEs indicate that there are no barriers to involvement in their organizations. Still, most CAEs report that a number of variables stand in the way of internal audit's involvement, most notably:

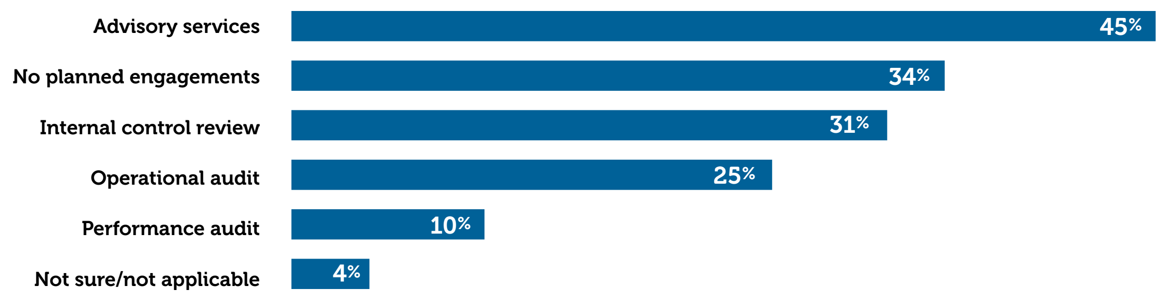
- Data to support ESG engagements is minimal or not readily available.
- ESG is not considered a priority in internal audit's plan.
- ESG is not part of the organization's culture.
- ESG is not included in ERM efforts. (See Figure 4.)

Figure 4: Barriers to Internal Audit Involvement

Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: What are the existing barriers to internal audit's involvement with ESG programs? Choose all that apply. *n*=102.

Going forward, two-thirds of CAEs indicate that they plan to perform ESG-related engagements over the next 12 months, with 45 percent planning advisory services and 31 percent planning internal control reviews (see Figure 5). Roberts suggests that "internal audit can be a key advisor in assessing the effectiveness of controls. ESG controls, especially for organizations that have not previously sought assurance, may be relatively new and immature for the level of rigor needed for accurate and complete reporting needed in public disclosures. Many organizations are still using informal processes and manual data collection for key ESG metrics which will need to be enhanced, as this data receives more scrutiny in the market and by regulators."

Figure 5: Planned ESG Engagements

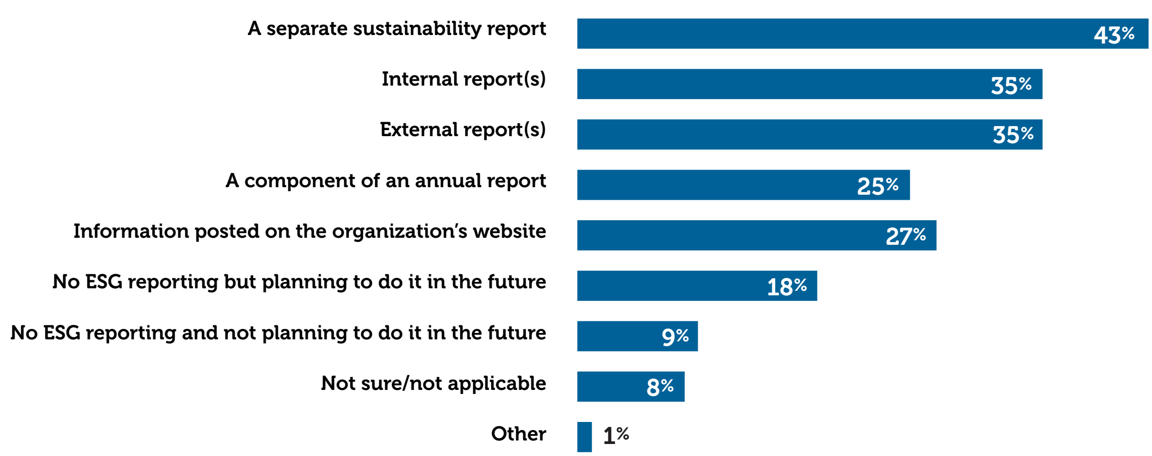


Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: Please indicate which types of ESG-related engagements your internal audit function has planned over the next 12 months. Choose all that apply. *n*=102.

How are organizations reporting ESG metrics?

As mentioned earlier, 54 percent of CAEs indicate that their organizations provide some type of ESG reporting, suggesting that organizations recognize stakeholder demands for ESG-related information. Most commonly, 43 percent produce a separate sustainability report, 35 percent produce an external and/or internal report, and 25 percent include ESG metrics on an annual report (see Figure 6). In addition to the reports identified, there is a growing movement and expectation for organizations to incorporate ESG metrics into financial reporting (e.g., financial statements, proxy statements, earning releases, investor communications). This information is continually being used by investors, including through analysis reports by ESG ratings agencies (e.g., Bloomberg, MSCI, Sustainalytics, ISS, Truvalue Labs, Thomson Reuters) that have detailed criteria, to make decisions that could expose the organization to risk if the report is not complete or accurate.

Figure 6: ESG Reporting Metrics

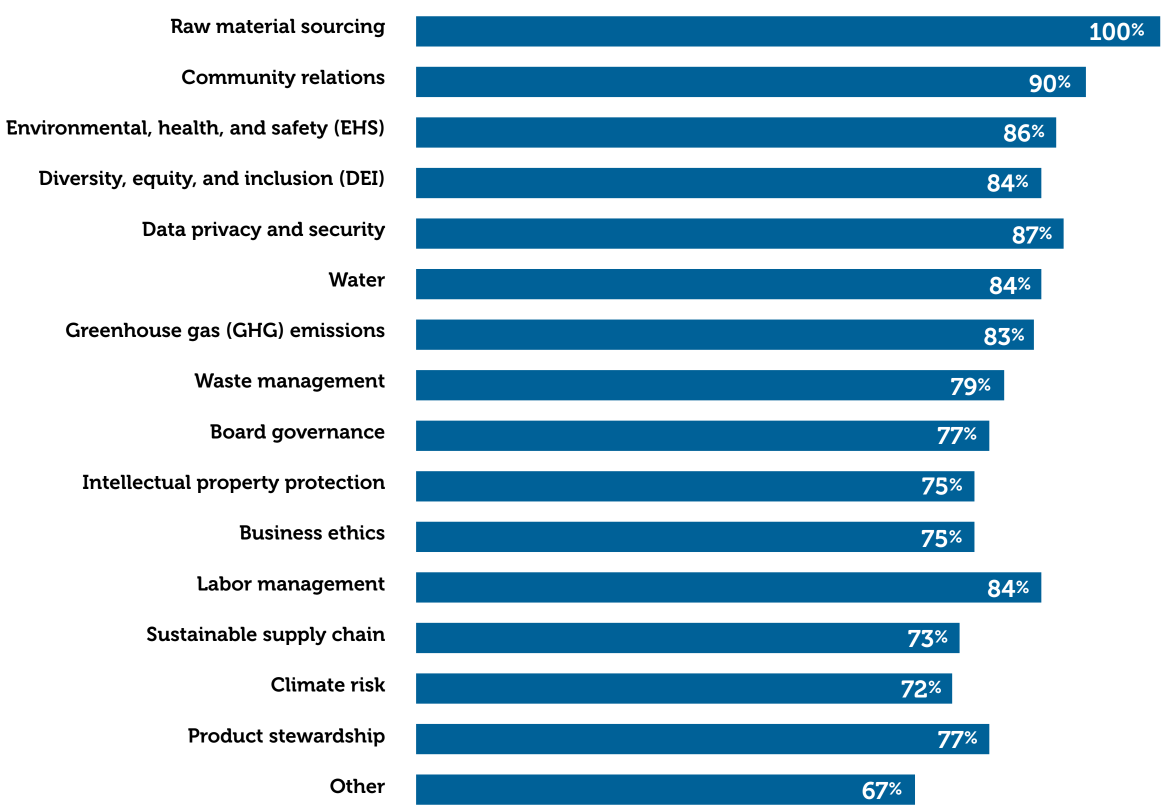


Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: How is your organization reporting ESG metrics? Choose all that apply. *n*=102.

ESG reports, whether internal or external, may include information on numerous topics. In the current survey, CAEs who selected elements in their organization's ESG program include the following topics in their ESG reporting:

- Raw material sourcing.
- Community relations.
- Environmental, health, and safety (EHS).
- Diversity, equity, and inclusion (DEI).
- Data privacy and security. (See Figure 7.)

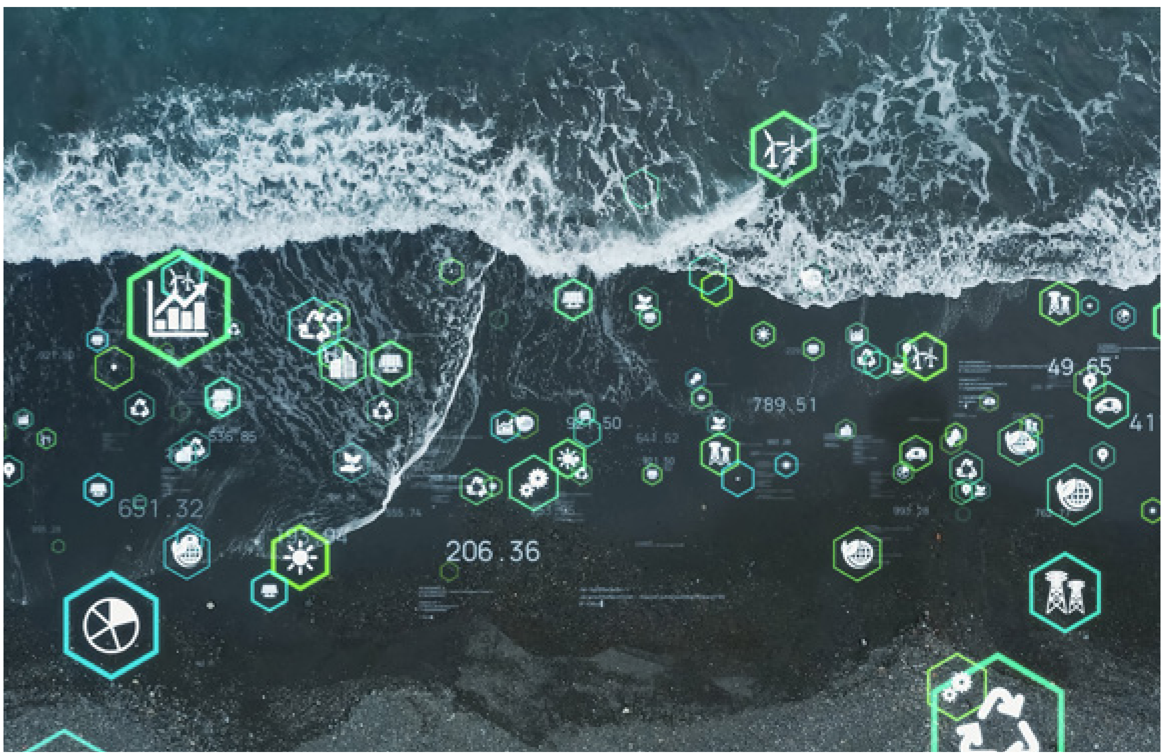
Figure 7: ESG Components Also Included in ESG Reporting



Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: Please indicate whether or not the following components of your organization's ESG program are included in your reporting mechanisms. If respondents chose an element of their ESG program (as seen in Figure 2), they were asked if reporting was included or not included for that element. *n*=83.

ESG reporting is not a simple exercise; it includes gathering and analysis of complex datasets without a formal framework outlining specific metrics and requirements for reporting. Nevertheless, there are numerous frameworks being used for ESG reporting (e.g., GRI, SASB, TCFD), and there continues to be a push toward globally standardized ESG reporting. As discussed, the announcement of the formation of the ISSB at COP26 made some progress in this regard. Until its realization, the lack of a globally accepted framework will hinder the accurate comparison of ESG program elements and metrics across organizations.

However, internal audit cannot wait to support its organization in achieving accurate and complete ESG reporting being demanded by the market. As previously mentioned, internal audit professionals are expected to have competencies related to corporate social responsibility and sustainability. Internal audit functions must act now to formally assess ESG risks that are material to an organization's performance as well as the accuracy and completeness of ESG disclosures.



What Is Next?

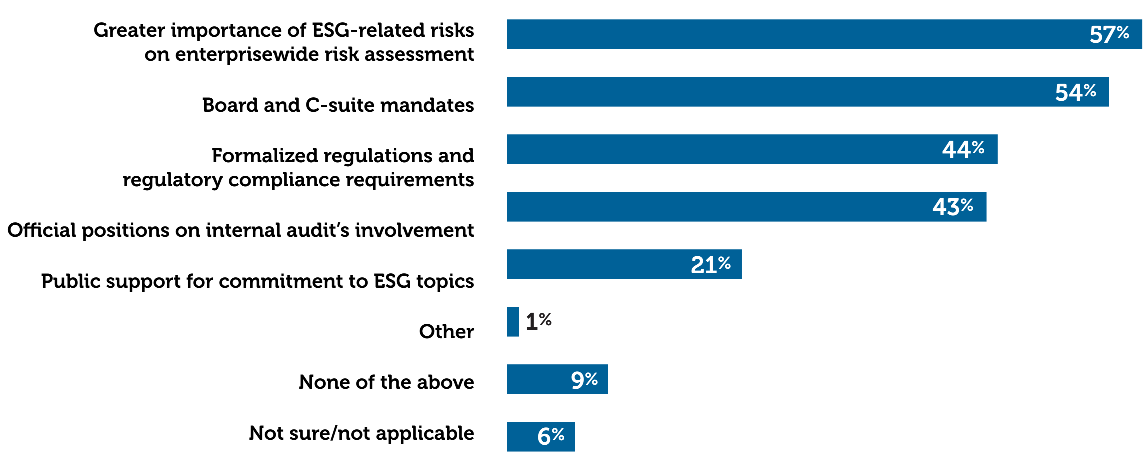
In the time that has passed since the survey, the pressure on organizations to manage ESG issues has intensified. For example, in September 2021, Harvard University announced plans to end its investments in the fossil fuel industry. It is anticipated that this could trigger similar action from other universities and possibly other industries.[v] As emphasized by Shannon Roberts, "Organizations, and their internal audit functions, need to anticipate what is coming next and how the business has responded."

What support and resources does internal audit need to move ESG forward proactively?

To move forward, more than half of CAEs indicate that their organizations need to place greater importance on ESG-related risks on the enterprisewide risk assessment and that board and C-suite mandates are needed. Forty-four percent state that regulations and regulatory compliance requirements are needed, while 43 percent express the need for IIA guidance and official positions on internal audit's involvement in ESG efforts (see Figure 8).

Until these needs are fulfilled, internal audit can help by elevating risks associated with ESG to the board and C-suite executives and being transparent about their position on the adequacy of involvement. In fact, while innovative thinking is required to address this increasingly important area, internal audit functions might start by performing ESG-related activities in the same way that Sarbanes-Oxley (SOX)[vi] activities are performed.

Figure 8: What Is Needed?



Note: Internal Audit Foundation/The IIA/EY Internal Audit Involvement in ESG Programs survey. Question: Please indicate which factors are needed to support internal audit's involvement in ESG-related initiatives. Choose all that apply. *n*=102.

According to Simon Wong, "Many of the internal audit executives view ESG as the next SOX. There are many parallels between today's ESG reporting landscape and how SOX developed in the early 2000s. Internal audit functions have an opportunity to get ahead of impending disclosure regulations and the ensuing assurance requirements by implementing a 'SOX-like' framework to enhance the reliability of ESG reporting within their organizations."

Organizations' internal audit functions also may leverage the Three Lines Model and COSO guidance on applying enterprise risk management to environmental, social, and governance-related risks.[vii] Effectively responding to accelerating ESG-related risks and opportunities requires integrating ESG into business strategy and ERM for a coordinated, strategic approach and strong oversight. When evaluating ESG reporting by topic and alignment with industry standards by sector, available guidance includes:

- CDP.[viii]
- Global Reporting Initiative.[ix]
- Sustainability Accounting Standards Board.[x]
- Climate Disclosure Standards Board.[xi]
- International Integrated Reporting Framework.[xii]
- Task Force on Climate-Related Financial Disclosures.[xiii]
- Science Based Targets initiative Net-Zero Standard.[xiv]

For most organizations and their internal audit functions, inattention to managing ESG risk is no longer an option. Organizations that fail to develop and implement effective ESG programs may not adequately manage ESG risk and could lose the trust of key stakeholders, such as potential investors, customers, and employees. They may also miss opportunities to unlock value from ESG, such as through innovation of products and services to capture larger market share or enhancing the organization's branding and relationships with stakeholders.

While the stakes might be overwhelming, Anne Munaretto encourages organizations to increasingly involve their internal audit functions — she expects 100 percent involvement in ESG within three years. However, Munaretto warns that "a key piece is to make sure that internal auditors gain the subject-matter expertise needed to make meaningful contributions; internal auditors should not expect to 'learn as they go' from ESG professionals who are already overburdened."

Wong agrees and suggests that internal audit functions start by understanding the organization's priority ESG issues. "Internal audit should review any stakeholder engagement and materiality assessments already undertaken by the organization and consider supplementing these with additional interviews as needed," Wong explains. "These conversations, even if limited in time and scope, can go a long way in helping internal audit identify critical ESG-related risks and existing initiatives to mitigate them."

"Another easy win is to start with reviewing current ESG reporting. Many organizations have publicly disclosed metrics around greenhouse gas emissions, community investment, and workforce diversity, for example, and often this nonfinancial reporting has not been validated or assured. Internal audit should review the completeness and accuracy of these metrics and underlying data, assess alignment with any industry standards or protocols, and evaluate management's reporting processes and controls," says Wong.

Shannon Roberts
Principal
Climate Change and Sustainability Services
Ernst & Young LLP
shannon.roberts@ey.com

Olusegun Ogunnaike
Partner
Consulting
Ernst & Young LLP
olusegun.ogunnaike@ey.com

Michelle Uwasomba
Partner
Consulting
Ernst & Young LLP
michelle.uwasomba@ey.com

Simon Wong
Senior Manager
Consulting
Ernst & Young LLP
simon.wong1@ey.com

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The Internal Audit Foundation has provided groundbreaking research for the internal audit profession for more than 45 years. Through initiatives that explore current issues, emerging trends, and future needs, the Foundation has been a driving force behind the evolution and advancement of the profession.

Endnotes

i https://na.theiia.org/standards-guidance/Pages/Mission-of-Internal-Audit.aspx
ii https://www.ey.com/en_gl/public-policy/three-dynamics-to-watch-on-global-climate-disclosure-standards
iii https://www.ey.com/en_gl/public-policy/three-dynamics-to-watch-on-global-climate-disclosure-standards
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vi The Sarbanes-Oxley Act of 2002
vii https://www.coso.org/Documents/COSO-WBCSD-ESGERM-Executive-Summary.pdf
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