Connect › Support › Advance

The Institute of Internal Auditors Australia

Whitepaper

ESG and the Role of Internal Audit

May 2022

Level 5, 580 George Street, Sydney NSW 2000 | PO Box A2311, Sydney South NSW 1235
T +61 2 9267 9155 **F** +61 2 9264 9240 **E** enquiry@iia.org.au **www.iia.org.au**
© 2022 - The Institute of Internal Auditors - Australia

ESG and the Role of Internal Audit

Contents

Background

Purpose

This White Paper has been written to build on IIA-Australia White Paper 'The Benefits of Addressing ESG Risk' (De Negri, 2022). It outlines the role internal audit can play supporting the growth of ESG outcomes for stakeholders. The White Paper specifically focuses on how internal audit can provide support with foundational skills, knowledge and experience.

Definition

The acronym ESG refers to the three distinct, but congruent, pillars of organisational sustainability: "Environmental, Social and Governance". These issues go well beyond the traditional considerations of financial stability.

Background

The IIA-Australia White Paper 'The Benefits of Addressing ESG Risk' outlined reasons why organisations should have a sharp focus on ESG, and the benefits holistic assessments in this space can have on companies and the wider global community.

This White Paper explores the role internal audit can play by developing, driving, supporting and assuring growth of ESG, and how this contribution can enhance the environment, our society and the global landscape as a whole.

In 1973, Fritz Schumacher famously coined the phrase in his book 'Small is Beautiful' to "*Think globally, act locally*". A big statement, however in the ever-expanding influence of ESG and evolution of stakeholder opinion, the phrase rings true to this day and will continue to do so. This is where the role of internal audit becomes extremely important. Internal audit can use its professional skills, ethical standpoints, analytical prowess and organisational influence to make small contributions setting the foundations for implementing ESG and the resulting benefits.

This White Paper outlines the crucial role internal audit can play in developing ESG assurance frameworks, synthesising big data into meaningful metrics and providing the important assurance vital to robust, transparent and valuable ESG implementation.

Discussion

Issue

Driving the ESG Agenda can be scary. There is a lot to consider and, in some cases, hearts and minds to win over. It is easier to be critical than create. Key questions to ask, answer and stand behind include:

- Who will take the first step in our ESG journey?
- Who will begin to align our data into meaningful information to support our ESG vision and ethos?
- Who will be able to assure us that we are reporting ESG outcomes accurately, fairly and transparently?

This White Paper seeks to assist in 'steering the ship' and provide guidance to help answer these questions.

History

ESG, in its current form, has been on board agendas since 2006 following the 'Freshfields Report' published by the United Nations Environment Programme Finance Initiative (UNEPFI) in 2005. The report stated:

> "*ESG considerations are capable of affecting investment decision-making in two distinct ways: they may affect the financial value to be ascribed to an investment as part of the decision-making process and they may be relevant to the objectives that investment decision-makers pursue.*"

Overall, the report concluded:

> "*Conventional investment analysis focuses on value, in the sense of financial performance. As we note above, the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible.*"

ESG and the Role of Internal Audit

Further to the above, the World Economic Forum Davos Manifesto 2020 stated:

> *"A company is more than an economic unit generating wealth. It fulfils human and societal aspirations as part of the broader social system. Performance must be measured not only on the return to shareholders, but also on how it achieves its environmental, social and good governance objectives."*

From this change in societal mindset, ESG became a key topic of discussion for boards and in many companies has become a standing agenda item. This is in part due to the complexities, intricacies and permeation of its impacts within business operations and strategy.

It has been reported that companies in the European Union will be required to make ESG disclosures from 2024 and in the United Kingdom many organisations will be required to make climate related disclosures from 2022 (Jones & Jessop, 2022).

So where does internal audit fit into this equation?

The challenge of valuing and disclosing ESG related impacts to an organisation can, and often does, fall on the finance function. But who actually validates the data to ensure it is accurately reported?

The Internal Audit Foundation White Paper '*Prioritising Environmental, Social, and Governance – Exploring Internal Audit's Role as a Critical Collaborator*' (Roberts, et al., 2022) says:

> *"Internal auditors provide the independent internal assurance needed for trustworthy ESG disclosures, and help ensure the effectiveness of continuous monitoring processes and internal controls across the organisation."*

Reporting Challenges and Complexities

With ESG, one of the major challenges is reporting accurately and responsibly. Although it is technically only one challenge, it has many components. Each component has its own set of cascading challenges which need to be considered, and importantly can be supported by internal audit as ESG independent assurer.

Prior to development of any ESG report, it is important to consider the wider community in a holistic way, for example the variety of stakeholders:

- Investors want relevant, consistent, comparable, trustworthy ESG information – just as they do for financial disclosures.
- Customer and client perspectives of company behaviour and corporate social responsibility are becoming increasingly important. Conveying information to a changing social perspective and outlining what makes your business ethically sound can be a challenge.
- Employees can often have strong views on ESG. Acknowledging this, in addition to driving change, can not only motivate the existing workforce, but also attract talent sharing the same vision. ESG reports can be tailored for this purpose.
- ESG is not currently mandated in Australia by policy makers. However, in some parts of the world, and for some industries, it is. This shift in ESG focus, and in particular those tasked with writing government policy, are crucial to consider when it comes to ESG reporting.

Adding to ESG reporting complexity is uncertainty around the format of standards, resulting in a need to manage multiple disclosure formats. At present there are a number of disclosure frameworks which support ESG reporting, including but not limited to:

- Carbon Disclosure Project.
- Global Reporting Initiative.
- International Sustainability Standards Board (ISSB).
- Sustainable Development Goals Disclosure.
- Task Force for Climate Related Financial Disclosures.

Even the above can in some cases be tailored to audiences. Similar to the Disney Pixar film 'Inside Out', it is useful to consider 'inside out' and 'outside in', and how each of the frameworks has typical target audiences, for example as shown below:

Method	Suggested Framework	Typical Audience
Inside Out – Impact Reporting	Global Reporting Initiative	Wider stakeholders
Outside In – Risk Reporting	ISSB	Investors

ESG and the Role of Internal Audit

In addition, ratings agencies tend to use differing frameworks as the Forbes table below outlines:

Framework	Rating Agency
Global Reporting Initiative	Morgan Stanley Capital International (MSCI)
Carbon Disclosure Project	Sustainalytics
Sustainable Accounting Development Board	RepRisk
Taskforce for Climate Related Financial Disclosures	ISS Environmental and Social QualityScore
Workforce Disclosure Initiative	Dow Jones Sustainable Indices
Climate Disclosure Standards Board	Bloomberg Professional Services
Principles for Responsible Investment	Financial Times Stock Exchange (FTSE) Russell
Sustainable Development Goals	Vigeo Eiris

With respect to accounting treatment, ESG can have impacts on a number of international accounting standards used to develop financial statements. Examples are outlined below relevant to users of financial information:

Standard	Relation to Financial Statements	Impacting Factors
IAS 1	Presentation of financial statements	Whether ESG financial and non-financial disclosures are relevant to users of financial statements
IAS 36	Impairment of assets	Stranded or obsolete assets in the balance sheet
IAS 37	Provisions, contingent liabilities and contingent assets	Liabilities where costs can be realised in the future
IAS 38	Intangible assets	Value of stakeholder perception and value of ESG initiatives
IFRS 9	Financial instruments	Potential increase or decrease of financial instrument value as to whether ESG components hold intrinsic value to investors
IFRS 13	Fair value measurement	Increases and decreases in ESG related assets

IAS – 'International Accounting Standards' issued by the International Accounting Standards Board (IASB)

IFRS – 'International Financial Reporting Standards' issued by the International Accounting Standards Board (IASB)

Clearly there is much to consider. Dr Martin Luther King Jr famously once said "*You don't have to see the whole staircase, just take the first step*", so let's do that now.

Solving the Reporting Equation

Firstly, we need to consider the components of ESG reporting, taking small bites from the bigger meal. These bites include:

- Reliable and accurate data.
- Oversight of all company operations.
- Presentation of data in a way which can be understood, repeated and replicated year-on-year.
- Defining a series of meaningful, comparative and repeatable metrics which provide a snapshot of the organisation and how it is performing.
- The impact of ESG activities (or lack thereof) on assets and liabilities.

The question now becomes: "*How can internal auditors not have a role to play in ESG for organisations?*"

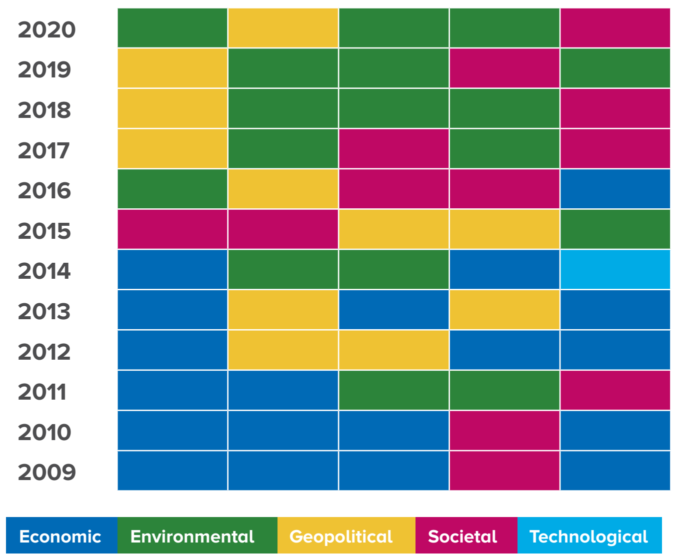
ESG and the Role of Internal Audit

Risk Management

There is a significant role for internal auditors to play in utilising risk management and analytical skills to assist organisations in understanding, assessing and recommending risk management strategies surrounding ESG.

The World Economic Forum published the 'Global Risks Report' in January 2022. This outlined the spectrum of top risks is changing – with a move away from economic risks to more ESG-related risks. As the diagrams below outline, each of the top five risk areas pertain to ESG, with an expected eight out of 10 within the next decade.

Top 5 Global Risks: Impact
Source: World Economic Forum Global Risks Perception Survey 2021-2022



"Identify the most severe risks on a global scale over the next 10 years"
Source: World Economic Forum Global Risks Perception Survey 2021-2022

1st	Climate action failure	6th	Infectious diseases
2nd	Extreme weather	7th	Human environmental damage
3rd	Biodiversity loss	8th	Natural resource crises
4th	Social cohesion erosion	9th	*Debt crises*
5th	Livelihood crises	10th	*Geoeconomic confrontation*

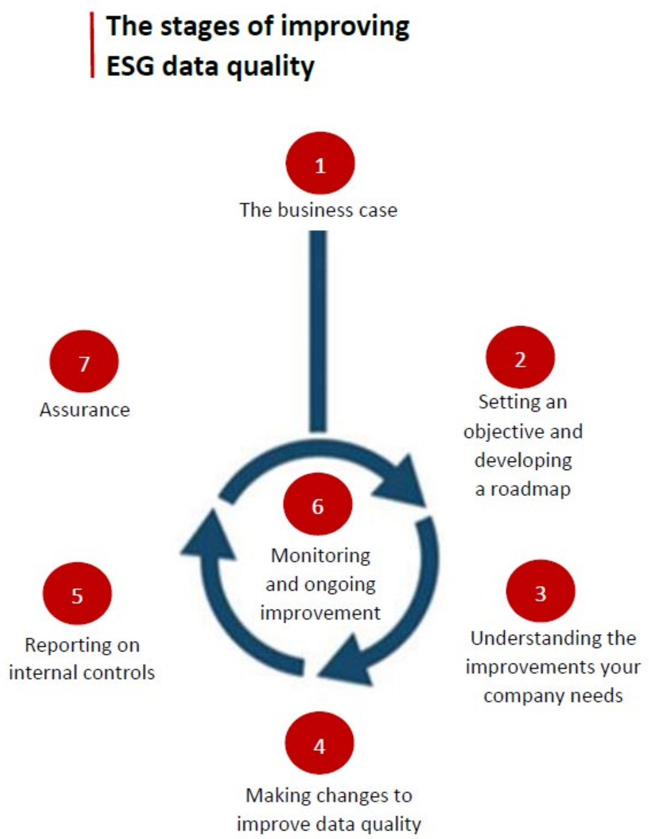
Economic | Environmental | Geopolitical | Societal | Technological

Providing risk management analysis to organisations is 'bread and butter' for internal audit. Internal auditors need to be across, understand and be able to scrutinise ESG risks and how this impacts organisations. From the risks above, it is clear there is a shift towards risks being more holistic, with a sharp move to people capital and how operations will impact humankind, rather than specifically the bottom line. The challenge is measuring the impact, in addition to providing assurance over controls in place to mitigate these risks.

Ensuring Data Integrity in ESG Reports

Good reports emanate from good data, with assurance of good quality data playing a key role in how reports are presented and how meaningful the information is for informed decision-making.

Consider the stages in ESG data quality outlined by the Association of Chartered Certified Accountant (ACCA) below:



ESG and the Role of Internal Audit

Metrics

Metrics are one thing, but meaningful metrics are something akin to unicorns – we all know in theory what they look like, but often they seem to be an impossible dream.

When we get closer to the conceptual aspects and key objectives of meaningful metrics, those unicorns turn into 'horses with ice-cream cones' which are far less intimidating.

The Project Management Institute (2002) outlined a helpful definition of meaningful metrics:

> *"Data must be well defined, accurate and relevant. In a nutshell, a metric is only as reliable as the data that's fed into it. Data is neither good nor bad, it's just numbers. To make it useful, you need to interpret it, and to do that you need to establish definitions. If you and I aren't counting things the same way, we can't compare them."*

From the sentence above, the standout words are 'Defined', 'Reliable' and 'Comparable'. When taking this into account, meaningful metrics for internal use can be extremely broad, which is helpful for comparative purposes. Below are some helpful examples from xChainge[1]:

As can be seen, there are several suggested metrics for each area of the diagram, and this is not an exhaustive list. Metrics should be considered from the following perspectives:

- Are we looking to measure internally at our own bespoke objectives?
- Are we selecting metrics based on the market so there can be comparison to peers?

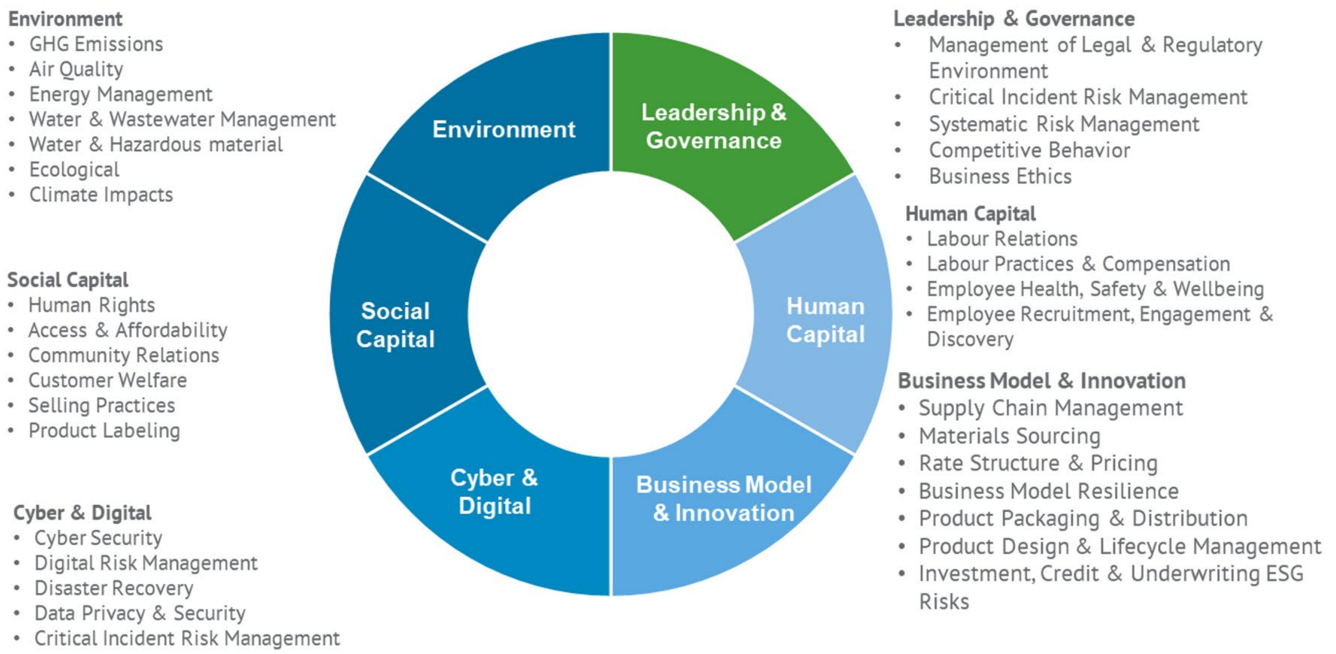
When we have our metrics, probably a maximum of 10 in total (it is better to do 10 well than 20 badly), we then move onto our next bite.

Benchmarking

The American Society for Quality (2002) states:

> *"Benchmarking is defined as the process of measuring products, services, and processes against those of organisations known to be leaders in one or more aspects of their operations. Benchmarking provides necessary insights to help you understand how your organisation compares with similar organisations, even if they are in a different business or have a different group of customers.*

> *"Benchmarking can also help organisations identify areas, systems, or processes for improvements – either incremental (continuous) improvements or dramatic (business process re-engineering) improvements."*



Source: xChainge 'ESG Beyond Corporate Financial Performance'

1 Xchainge Global Pty Ltd. https://xchainge.com.au

ESG and the Role of Internal Audit

The crucial takeaway messages from the statement above are:

- Measurement against other leaders.
- Identification of areas for improvement.

The definition above leads directly into the purpose of ESG benchmarking and the overall vision and ethos of the activity.

The Role of Internal Audit

There is a clearly a role for finance in ESG reporting, but what about internal audit? The two aspects of competency – knowledge and experience – work in symbiosis for effective ESG reporting. Key components and specific skills internal audit can bring include:

- As trusted advisors, it is an internal audit responsibility to support their organisation to promote improvements in efficiency, long-term viability and business practices. Internal auditors are well placed to review and provide comfort over ESG data, reporting and integrity, as well as conveying to the audit committee that ESG can support achievement of strategic objectives.
- The skills, knowledge and experience internal audit has with respect to providing assurance over processes and controls is crucial for accurate and transparent ESG reporting. It is important for ESG reporting to be true, fair, honest and open. The value internal audit can provide to assure these key components cannot be overstated.
- Confirm that ESG aspects are included in risk management activities. This is not only crucial given the importance of the subject, but also makes perfect sense. Risk assessments including ESG factors at both the strategic and operational levels should be key for all organisations going forward.

It is important to note the internal audit role in ESG is not a one-off or isolated exposure. ESG should become an important aspect of internal audit risk assessments, internal audit planning and potentially engagements. The internal audit role is iterative and can permeate the full internal audit lifecycle as the table below suggests:

It is not a straight track, but a circuit. We can continue to do laps to support our ESG journey with the hope of one day winning the race.

Stage	Internal Audit Involvement
Risk Assessment and Internal Audit Plan	› Identification of ESG related risks which can impact strategic and operational plans. › As trusted advisors, internal audit can conduct ESG-related advisory services and include ESG within assurance engagements.
Engagement Planning and Fieldwork	› Development of internal audit programs to ensure ESG processes and controls are designed and operating effectively. › Internal audit work can identify the root cause of issues, including those impacting strategic and operational objectives.
Reporting and Stakeholder Communications	› Proposing the most effective reporting methods including integrated and standalone reports to the audit committee and board. › Crafting value-adding improvement recommendations to improve ESG performance within an organisation.

ESG and the Role of Internal Audit

Conclusion

Summary

Internal audit can contribute to ESG in organisations. Three key takeaway messages are:

- It may seem complex, but the internal audit skills are perfectly suited to an assurance role with ESG reporting.
- Be confident in your internal audit skills, knowledge and experience to assist ESG reporting.
- It is a journey to be taken one step at a time.

"*Think globally, act locally*" has a tangible meaning for internal audit in relation to ESG. Although a relatively new concept, ESG can be enhanced, implemented and reported using the internal audit skills we already have, and methods we already know and have used time and again. It is a new area of focus, but the challenges can be tackled the same way with the same level of professionalism.

> *Usain Bolt used to run 200-metre sprints. However, he took a new challenge for the 100-metre event and used the skills he had, the training he had conducted, and the vision he was born with, to tackle the change and to thrive.*

The work we deliver in this space can appear small, but every metric we run, every benefit we attempt to quantify and every report we share, is progress. It is a step in the right direction and an act that edges towards a sustainable planet for us all.

Conclusion

ESG is a fast-paced environment which is a reminder of a famous quote being "*How fast does a zebra have to run before it looks grey*". The same maxim can be applied to ESG, however it is important to look past the 'grey' and remember the black and white stripes are unique, form distinct patterns, and contribute to the holistic beauty of the animal.

To reiterate the IIA-Australia White Paper 'The Benefits of Addressing ESG Risk', it is clear the world is demanding action, which is something we as internal auditors can all play a part in across each of the three ESG pillars.

Bibliography and References

American Society for Quality, 2022. What is Benchmarking?. [Online]
Available at: https://asq.org/quality-resources/benchmarking

Atkins, B., 2020. Demystifying ESG: Its History & Current Status. [Online]
Available at: https://www.forbes.com/sites/betsyatkins/2020/06/08/demystifying-esgits-history--current-status/

De Negri, K., 2022. White paper: The Benefits of Addressing ESG Risk. [Online]
Available at: https://iia.org.au/sf_docs/default-source/technical-resources/2018-whitepapers/iia-whitepaper_the-benefits-of-addressing-esg-risk.pdf

IFRS Foundation, 2021. Issued Standards. [Online]
Available at: https://www.ifrs.org/issued-standards/

Jones, H. & Jessop, S., 2022. Corporate sustainability push a $35 trillion dollar conundrum for auditors. [Online]
Available at: https://www.reuters.com/markets/funds/corporate-sustainability-push-35-trillion-dollar-conundrum-auditors-2022-02-22/

Roberts, S. et al., 2022. Prioritizing Environmental, Social, and Governance: Exploring Internal Audit's Role as a Critical Collaborator. [Online]
Available at: https://www.theiia.org/globalassets/site/foundation/latest-research-and-products/2021-3910-fnd-prioritizingesg-report_final_v6.pdf

Schumacher, E. F., 1973. Small Is Beautiful. A Study of Economics As If People Mattered. London: Blond & Briggs.

United Nations Environment Programme Finance Intitiative, 2005. A legal framework for the integration of environmental, social and governance issues into institutional investing. [Online]
Available at: https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf

Webster, J. S., 2002. Meaninful metrics. PM Network, 16(11), pp. 34-39.

World Economic Forum, 2020. Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution. [Online]
Available at: https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-

© 2022 - The Institute of Internal Auditors - Australia

ESG and the Role of Internal Audit

fourth-industrial-revolution/

World Economic Forum, 2022. Global Risks Report. [Online] Available at: https://www3.weforum.org/docs/WEF_The_Global_Risks_Report_2022.pdf

Purpose of White Papers

A White Paper is a report authored and peer reviewed by experienced practitioners to provide guidance on a particular subject related to governance, risk management or control. It seeks to inform readers about an issue and present ideas and options on how it might be managed. It does not necessarily represent the position or philosophy of the Institute of Internal Auditors-Global and the Institute of Internal Auditors-Australia.

Author's Biography

This White Paper written by:

Ken De Negri BSc, MSc, FCCA, PMIIA

Ken is a Senior Manager with over 11 years of experience with ESG in both the public and private sector in the UK and Australia. He has led engagements involving environmental reporting, ISO 14001 environmental management systems, sustainable business network development and carbon foot-printing. Ken also assisted in developing sustainability reporting which provides stakeholders with assurance that business and sustainability objectives rare aligned. He is a registered Climate Active Consultant.

On a personal note, Ken is extremely passionate about ESG, starting from a focus on an environmental and sustainable development standpoint and has developed this into a further passion for social, societal and humanitarian perspective. This coupled with experience in risk management and governance consulting enables Ken to combine passion, expertise, and experience to drive change within organisations, and it is his hope, the world.

He takes great pride in the work he does in the ESG space and has spoken at events including the NSW IIA Chapter and the Asian Confederation of IIA Leadership Forum. Ken is the author of the IIA-Australia White Paper 'The Benefits of Addressing ESG Risk'.

This White Paper was edited by:

Andrew Cox MBA, MEC, GradDipSc, GradCertPA, DipBusAdmin, DipPubAdmin, AssDipAcctg, CertSQM, PFIIA, CIA, CISA, CFE, CGAP, CSQA, MACS Snr, MRMIA

Michael Parkinson BSc (Hons), GradDipComp, PFIIA, CIA, CISA, CRMA, CRISC

About the Institute of Internal Auditors–Australia

The Institute of Internal Auditors (IIA) is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world including Australia.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

The IIA-Australia ensures its members and the profession are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 200,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

Copyright

This White Paper contains a variety of copyright material. Some of this is the intellectual property of the author, some is owned by the Institute of Internal Auditors-Global or the Institute of Internal Auditors-Australia. Some material is owned by others which is shown through attribution and referencing. Some material is in the public domain. Except for material, which is unambiguously and unarguably in the public domain, only material owned by the Institute of Internal Auditors-Global and the Institute of Internal Auditors-Australia, and so indicated, may be copied, provided that textual and graphical content are not altered, and the source is acknowledged. The Institute of Internal Auditors-Australia reserves the right to revoke that permission at any time. Permission is not given for any commercial use or sale of the material.

ESG and the Role of Internal Audit

Disclaimer

Whilst the Institute of Internal Auditors-Australia has attempted to ensure the information in this White Paper is as accurate as possible, the information is for personal and educational use only, and is provided in good faith without any express or implied warranty. There is no guarantee given to the accuracy or currency of information contained in this White Paper. The Institute of Internal Auditors-Australia does not accept responsibility for any loss or damage occasioned by use of the information contained in this White Paper.