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Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

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Internal Audit and the Board's ESG Committee

Environmental, social, and governance (ESG) concerns have taken on persistent urgency for boards, and the numbers clearly back this up. In its proxy season review for 2022, EY asked investors to identify the biggest drivers of strategic success in the next three to five years. The top choice—picked by 69% of investors—was integration of material ESG opportunities into strategy. That was up from 47% in 2021. When asked to choose the greatest threats to strategic success, 58% cited climate risk and natural resource constraints, compared with 52% who said so the year before.

Growing ESG concerns are clearly manifesting themselves in greater demands on boards. The same EY survey found 73% of investors said ESG oversight would be a more important factor in how they evaluate and vote on directors than it was in 2021, with climate risk a key focus area.¹

When it comes to sustainable business practices, “underlying these expectations and areas of focus are investors’ conviction that more effective management of business-relevant environmental, social, and governance (ESG) issues will lead to better financial performance,” EY said. Efforts on sustainability reporting and disclosure are also coming into focus, with the U.S. Security and Exchange Commission’s [proposed mandatory climate-risk disclosures](#) and proposed sustainability and climate reporting standards issued by the [International Sustainability Standards Board](#).

The Value of ESG Assurance

Internal audit has a unique role in governance as a source of objective assurance, independent of management. Opening up communications between internal audit and the board committee that oversees ESG ensures that this group has firsthand access to internal audit’s independent advice and assurance on ESG concerns. Internal audit might typically report to the audit committee of the board, but it should maintain critical connections with other committees, as well.

A Deloitte report found that there is a great deal of diversity in ESG oversight. At the largest percentage of S&P 500 board



committees (41%), it is the responsibility of the nominating and governance committee. Another 10% have an ESG/sustainability committee, while smaller percentages assigned it to other committees, to the full board, to a health and safety committee, or to the audit committee. “The current variability in committee oversight of ESG will likely evolve to fit the unique ESG objectives of each company,” Deloitte concluded.²

It is important that internal audit has a continuing, direct line of communication with whichever committee oversees ESG. Some of the compelling reasons include:

- » Internal audit can provide insights the committee and the board may be missing. Professional internal auditing standards clearly establish internal audit’s role in providing assurance over risk management, which should include an organization’s ESG reporting process and controls. However, although ESG-related issues can quickly mature into material risks, only 51%

About The IIA

The Institute of Internal Auditors, Inc. is a global professional association with more than 210,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

The IIA

1035 Greenwood Blvd.
Suite 401
Lake Mary, FL 32746 USA

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of organizations that are reporting on ESG obtain some level of independent assurance, according to research by The Institute of Internal Auditors (IIA) and the Internal Audit Foundation, in collaboration with EY.

The research found that in organizations that do involve internal audit, just under 30% of chief audit executives are engaged in key ESG considerations. Their contributions can include consulting on ESG program goals and metrics, reviewing how ESG goals and metrics are tracked and monitored, assessing implementation of the ESG program and related policy documents, and evaluating the accuracy of ESG reports provided to stakeholders. But as Figure 1 on page 3 shows, a minority of organizations are taking advantage of the value that internal audit can offer in these areas.³

- » Internal audit's input can fall into a number of categories. "Using their knowledge of the company's operations, internal audit can make recommendations about processes, control design, and data governance," according to PwC. "It can also help with compliance and monitoring consistency and comparability by benchmarking the company's efforts against its peers."⁴

In general, internal audit plays two important roles in organizations, both of which are relevant to ESG considerations. As a provider of independent assurance, internal audit can:

- » Help ensure the organization is using the appropriate metrics and that they are accurate, relevant, up to date, and consistent. This is particularly important given the heightened regulatory focus.
- » Help coordinate financial and nonfinancial disclosures. Sustainability reporting provides nonfinancial data, which should not conflict with formal financial disclosures.
- » Conduct materiality or risk assessments on ESG reporting. This area can be potentially problematic because organizations sometimes struggle with understanding and reporting what standard-setting organizations consider "material."
- » Incorporate ESG into audit plans. Sustainability/nonfinancial reporting audits account for just 1% of the average audit plan allocation, according to The IIA's *2022 North American Pulse of Internal Audit*. Given the appropriate resources, internal audit can incorporate this multifaceted concern into its comprehensive review of the organization.

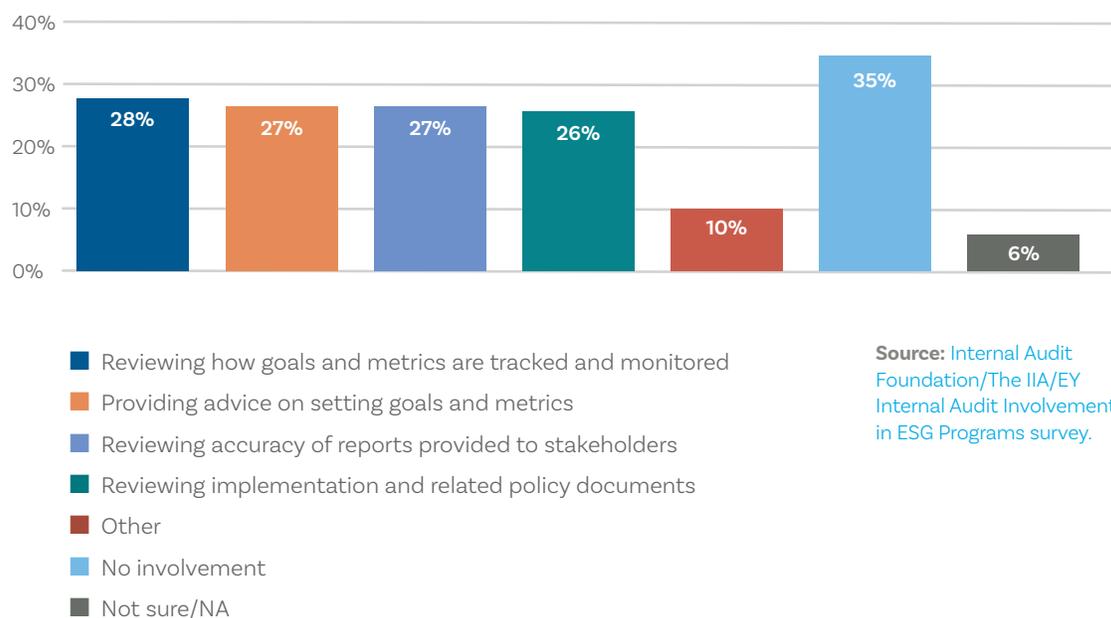
In its advisory role, internal audit can:

- » Assist in developing relevant ESG-related controls. Internal audit teams can recommend the most appropriate ESG reporting frameworks and establish internal controls specific to the organization.

QUESTIONS FOR BOARD MEMBERS

- » Are ESG considerations central to our corporate culture?
- » Are ESG issues given priority in the organization's audit plan?
- » Does internal audit have sufficient resources to offer comprehensive, independent advice on ESG concerns?
- » Does the organization limit ESG assurance to external sources?
- » Does internal audit have the ability to report directly on ESG to the board or the relevant board committee?

Figure 1: Internal Audit Involvement in ESG



- » Support the design of or advise on appropriate metrics. Where to focus reporting is a critical consideration in managing ESG reporting risks. Internal audit can provide advice on what data (quantitative and qualitative) will accurately reflect the organization’s sustainability efforts.
- » Advise on ESG governance. Internal audit has a unique, holistic understanding of risk across the organization. As a result, it can help identify governance roles and responsibilities, as well as provide training on internal control.⁵
- » Involving internal audit is an acknowledged strategy for advancing ESG maturity. A Deloitte ESG Maturity Model tracks an organization’s progress from “responsive” to “enhanced” to “integrated.” One of the elements that characterizes a company in the “enhanced” stage is that “internal audit reviews ESG governance, processes, controls, and data on ad hoc basis.” One sign that an organization has moved up to the ultimate “integrated” stage would be that its “internal audit plan includes annual review of ESG governance, processes, controls, and data.”⁶ When boards consider where their organizations stand in their ESG journey, the role of internal audit should be a key consideration.
- » Internal audit’s contribution is based on deep knowledge of the organization and of ESG considerations that may not be available from other sources. “As boards discuss ESG disclosures, they may want to consider assurance over the metrics and information reported,” noted a blog from the National Association of Corporate Directors (NACD). “Nonfinancial data are not typically included in financial statements, so they may not belong under the scope of external audit’s assessment.” The NACD points out that internal audit can offer additional assurance that ESG processes and policies are followed and effective.⁷



A Critical Partner

According to 62% of chief audit executives, boards of directors or the equivalent are driving their organization’s focus and integration of ESG strategy and reporting.⁸ With so much at stake, this is clearly the time to give precedence to ESG concerns. As boards spotlight this priority, internal audit can be a critical partner to the board committee charged with ESG oversight, playing an important role in monitoring and reporting on the organization’s efforts and advising on effective solutions.

Endnotes

- 1 “2022 Proxy Season Preview: What Investors Expect From the 2022 Proxy Season,” EY Center for Board Matters, 2022.
- 2 “On the Audit Committee’s Agenda: Defining the Role of the Audit Committee in Overseeing ESG,” Deloitte Center for Board Effectiveness, November 2020.
- 3 “Prioritizing Environmental, Social, and Governance: Exploring Internal Audit’s Role as a Critical Collaborator,” Internal Audit Foundation, 2022.
- 4 “The Audit Committee’s Role in Sustainability/ESG Oversight,” PwC Governance Insights Center, September 2021.
- 5 “Internal Audit’s Role in ESG Reporting: Independent Assurance Is Critical to Effective Sustainability Reporting,” The IIA, May 2021.
- 6 “On the Audit Committee’s Agenda: Defining the Role of the Audit Committee in Overseeing ESG,” Deloitte Center for Board Effectiveness, November 2020.
- 7 “How Boards Can Ensure the Accuracy and Quality of ESG Data,” NACD BoardTalk, March 24, 2021.
- 8 “Prioritizing Environmental, Social, and Governance: Exploring Internal Audit’s Role as a Critical Collaborator,” Internal Audit Foundation, 2022.

Quick Poll Question

Does your organization leverage internal audit for ESG assurance?

- Yes, internal audit is fully incorporated into our ESG risk management strategy.
- Yes, but only on an ad hoc basis.
- We have not yet articulated a strategy for ESG internal control and assurance.
- No, we do not include ESG in internal audit’s scope of work.

Visit theiia.org/Tone to answer the question and learn how others are responding.

QUICK POLL RESULTS

Is the Board aware of how the internal audit plan reflects the organization’s risk priorities?

(Respondents could only choose a single response)

71.64%

Yes

17.41%

No

10.95%

Don’t know



Source: Tone at the Top April 2022 Survey.