



Internal audit's role in ESG

**Businesses are facing a new
challenge: ESG risk**





Contents

3

The rise of ESG risk

6

Internal audit has a clear role to play

9

ESG internal audit methodology

11

How can KPMG help?





The rise of ESG risk



Environmental, social and governance (ESG) issues are becoming increasingly relevant for all organizations today. Companies understand that embracing ESG enhances their ability to secure limited talent, strengthen the employee experience, attract loyal customers and raise capital. ESG has gone from a nice-to-have to an integral piece of long-term financial success.¹

As a result, sustainability is generating a new type of risk: ESG risk. Companies have begun reimagining their governance structures over ESG, creating executive steering committees and making strategic decisions about commitments, actions and disclosures.² Companies are also adjusting business-risk strategies and risk-appetite statements — making sure roles and responsibilities are fully transparent across all three lines of defense.

Internal audit can play a critical role in providing objective assurance and advice on ESG reporting and sustainability matters more broadly.

Stakeholder expectations have pressured companies to shift their focus from maximizing shareholder returns to maximizing shareholder value, prompting organizations to publicly report sustainability commitments and strategies. With a potential recession looming and today's hypercompetitive environment testing CEOs' commitment to ESG strategies, reducing investment may lead to long-term financial risks.

This test comes at a time when CEOs have made significant strides in tying ESG to profitability, and it becomes a matter of prioritizing short-term and long-term returns.³

¹ KPMG 2022 Global CEO Outlook, August 2022.

² KPMG 2022 Global Sustainability Reporting Survey, September 2022.

³ KPMG 2022 US CEO Outlook, August 2022.

⁴ KPMG in the US, The ESG journey to assurance, 2022.

Staying on top of the challenge

Regulatory, investor and stakeholder pressure

A comprehensive ESG strategy is now essential to address stakeholder requirements and regulation as well as to build competitive advantage, improve resilience, and drive value. Regulators are looking to companies to lead the environmental and governance changes required to meet sustainability goals in the long term and notable regulations in various global jurisdictions have either recently been enacted or pending final passage. As a result, companies will come under greater pressure to reorient their business to sustainable activities.

Great ESG expectations

ESG has become a business imperative, impacting financial resilience, growth and stakeholder expectations. Failing to meet ESG expectations poses challenges that can affect financing, talent recruitment, competitiveness, threats to tenure, employee satisfaction and the loss of customers.⁴

What is ESG?



Environmental

considers how an organization performs as a steward of nature. This can include issues related to financed emissions, waste management, water management and climate-change vulnerability.



Social

examines how organizations manage relationships with employees, customers and the wider community. Risks that fall under this category can include corporate social responsibility, labor management, data privacy, general security, health and safety and well-being.



Governance

refers to variables such as business ethics, boards and leadership, executive pay, audits, internal controls, intellectual property protection and shareholder rights.

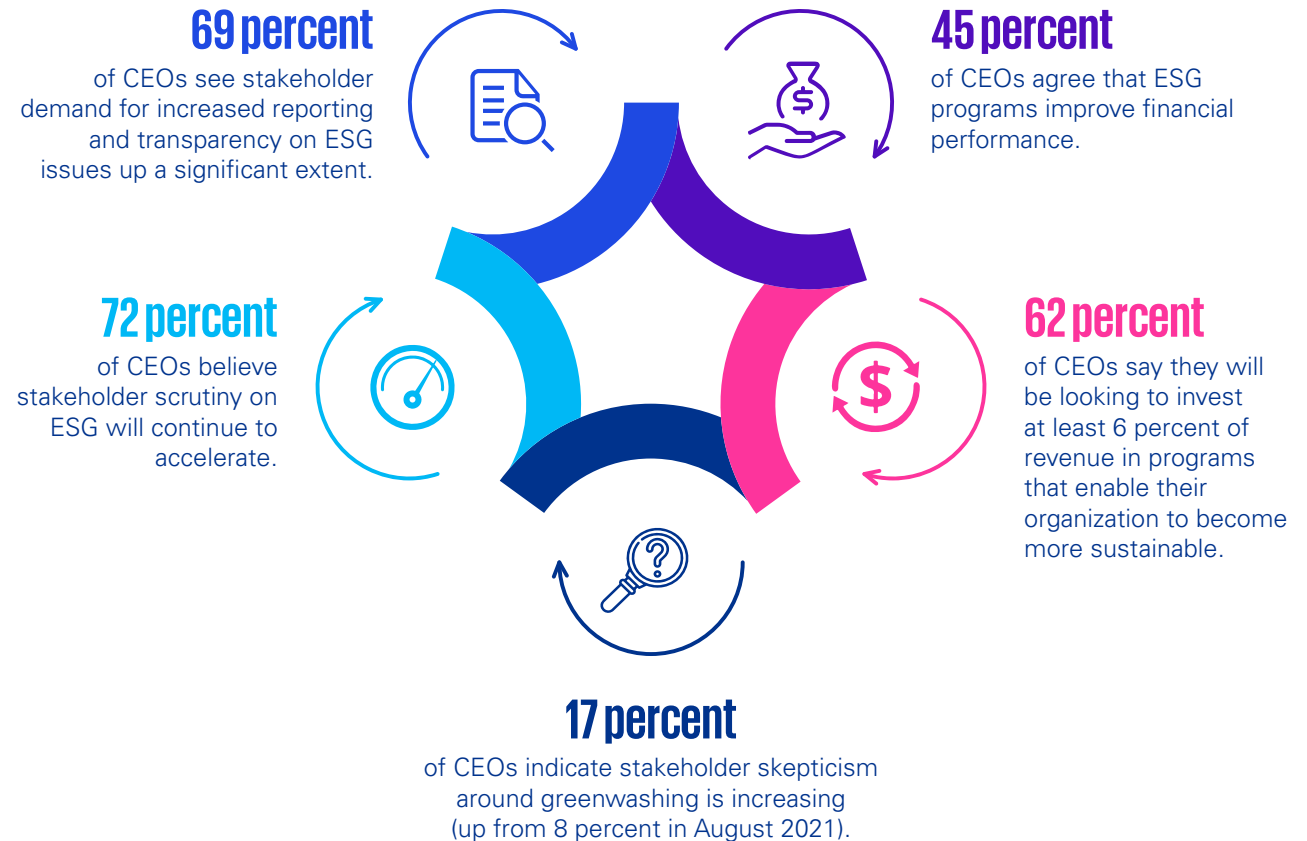


No-regret moves

Each company's sustainability journey is unique. Companies just beginning their journey should align their strategy to their unique needs and not approach it from an ESG-in-a-box solution. Rather than waiting, there are several no-regret moves companies can initiate. These include: understanding stakeholder expectations, determining strategic imperatives against key ESG topics, defining key metrics and investing in quality non-financial data management.

As with financial reporting, the independent and objective assurance that internal audit can provide must be an integral part of an organization's ESG response.

CEO ESG outlook



Source: KPMG 2022 CEO Outlook.



Internal audit has a clear role to play





Internal audit is in a unique position to provide guidance, add value and leverage its experience to implement effective change. Guidance to operationalize ESG strategies and goals in a manner that's subject to internal controls amid upcoming changes is imperative. According to the Institute of Internal Auditors, internal audit has clear roles that may include the following in providing assurance and advisory ESG services:

Assurance

- **Internal audit's undeniable role in ESG reporting:** ESG systems and controls need time to mature and require internal audit's first look prior to facing inevitable external auditor scrutiny.
- **Review reporting metrics for relevance, accuracy, timing and consistency:** Providing public ESG reports and non-financial information that accurately depict an organization's ESG efforts is critical. Conflicts with formal financial disclosures will raise a red flag with investors and regulators as regulatory oversight and public scrutiny increases.
- **Conduct materiality or risk assessments on ESG reporting:** Ongoing ESG efforts or public commitments to reaching ESG goals can quickly give rise to higher levels of materiality.
- **Incorporate ESG into regular audit plans:** Internal audit has deep corporate knowledge — culture, ethics, governance frameworks and processes and their related risks — and should come to recognize ESG-related assurance engagements in the future.

Advisory

- **Identify areas that are less well-defined and build an ESG control environment:** Internal audit can initiate discussions that are not quite ready for assurance involving regulatory guidelines or expectations and advise on internal controls for ESG reporting.
- **Recommend reporting metrics:** Internal audit can provide insights into the kind of data that accurately reflects relevant ESG efforts within the organization.
- **Advise and advocate on ESG governance:** Internal audit can provide guidance on ESG governance due to its holistic understanding of risk across the organization, and advocate for the company to approach ESG risk in a thoughtful manner.

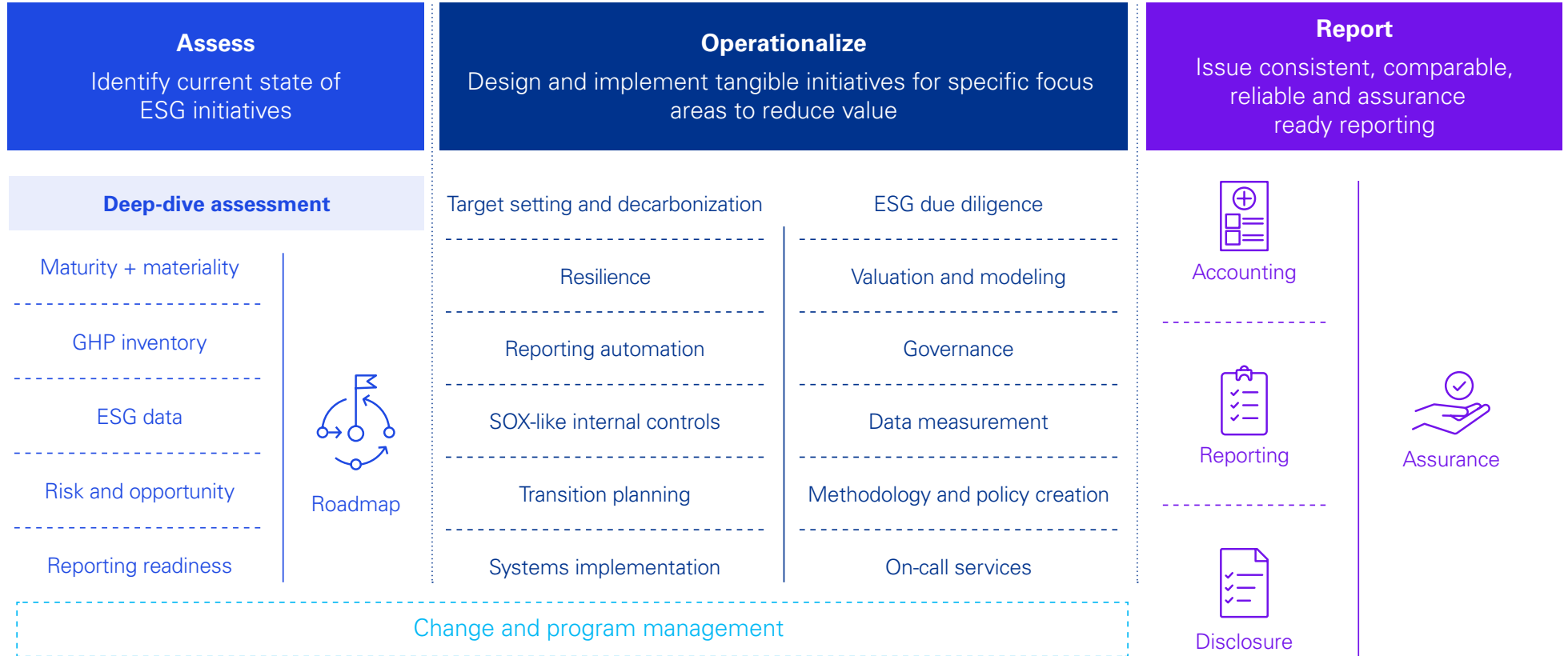
Internal audit can support management with answers to key questions

1. Does the business have a clear view of all ESG risks and opportunities, including compliance risk related to existing and upcoming regulatory expectations, such as the EU Corporate Sustainability Reporting Directive (CSRD) and the SEC's proposed Climate Disclosure Rule. Further, how is the business preparing to regularly reassess and monitor related risks?
2. Is the business prepared for upcoming legislative and regulatory expectations in all key jurisdictions?
3. Does an ESG culture and risk-management approach exist that aligns to ESG goals and strategies?
4. What are the business's current public ESG commitments, and does the business have policies, procedures, controls and data to support them?



The ESG journey

Internal audit can play a critical role in each phase of a company's ESG journey:



Key drivers

Stakeholder opinion

Stakeholders, customers, employees and other stakeholders linking climate to risk management, value creation and brand reputation.

Regulations

Rising regulatory expectations and/or mandates in areas of climate risk management, governance, board/management accountability and reporting.



ESG internal audit methodology





Internal audit's ESG mandate should go beyond simply identifying risks and controls. It should link strategy, governance and risk management to help ensure internal programs, initiatives, controls and supporting technologies are effective organization wide. The KPMG ESG internal audit approach combines different elements of our established internal audit methodology, supplemented by KPMG firms' internal expertise in ESG.

Internal audit coverage across key ESG categories

Enterprise-wide considerations

- Definition of ESG
- Mission, vision, values and strategy
- Periodic review by top management
- Context and stakeholder analysis
- Time, resource and budget

Reporting

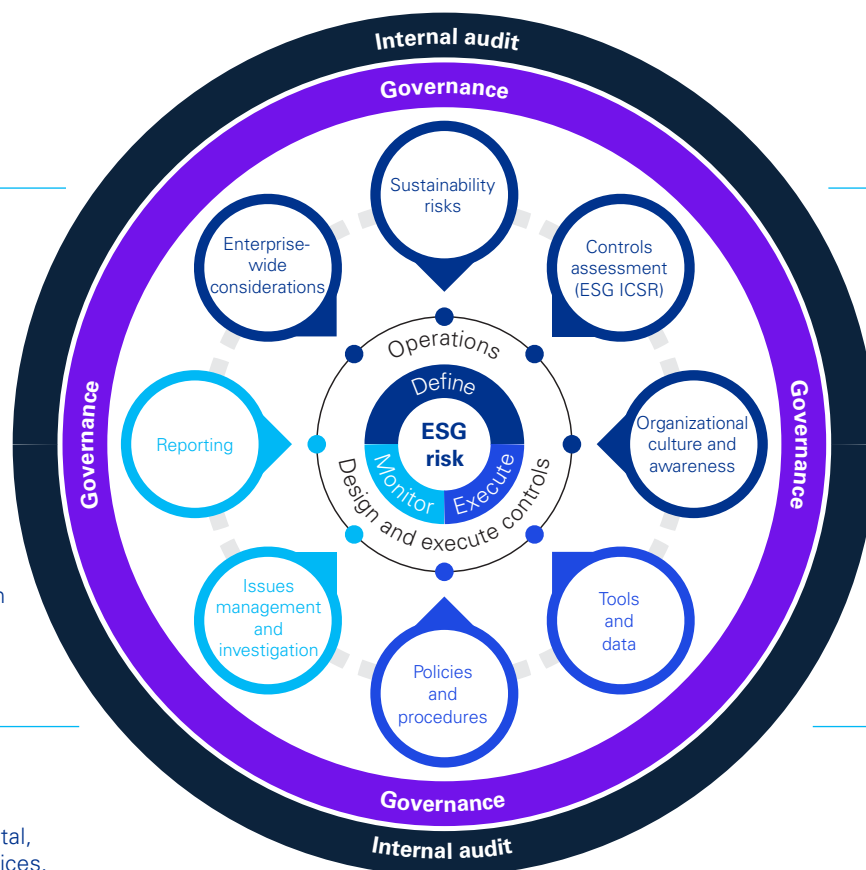
- Regulatory reporting across relevant jurisdictions
- Periodic reporting to management and the board
- External reporting to stakeholders
- Record keeping

Issues management and investigation

- Issues and complaints management and remediation
- Responding to regulatory examination/inspection
- Response plan and a process for investigating alleged non-compliance
- Continuous improvement

Policies and procedures

- ESG policy existence and management
- Entity-wide policies and procedures (human capital, health and safety, cyber, lending and credit practices, investments, etc.)
- Consistency between policy framework and strategy



Sustainability risks

- Risk (and opportunity) assessment
- Regulatory requirements
- Transformation integrity
- Third-party due diligence

Controls assessment

- Monitoring and tracking regulatory changes
- Process and control testing
- Periodic ESG risk-program evaluation
- Coordination with other assurance providers such as second line

Organizational culture and awareness

- Engage and create dialogue with key stakeholders
- Address the culture and tone of ESG/ sustainability and behavioral change
- Regular and frequent training and communication

Tools and data

- Technology to support the ESG program (testing, training records, etc.)
- Predictive measures: key risk indicators and key performance indicators
- Root-cause analysis and trending
- Data governance/management



How can KPMG help?





The KPMG Internal Audit methodology is flexible and can be tailored to each company’s specific needs. Internal audit service offerings can range from examining aspects of the company’s ESG governance policy — such as high-level oversight, risk assessment, due diligence procedures, and awareness — to assessment of controls to support ESG commitments. The suite of assessments identified on the next page can be separately performed or executed in phases as part of an overall readiness ESG assessment.

ESG governance assessment	Internal controls over sustainability reporting	ESG in internal audit
Objectives		
<p>Assess the organization’s ESG governance structure in alignment with recognized standards (e.g., COSO-ICSR 2023 release). Assessment may include:</p> <ul style="list-style-type: none"> • Board oversight and committee structures. • Materiality assessment review and determination of reporting objectives. • Policies and procedures. • Strategy to link identified ESG risks to business imperatives and business model. • Operational plan implementation (target operating model implementation). • Internal assurance framework. <p>KPMG accelerator: ESG governance framework with leading practices underpinned by the COSO Internal Control Over Sustainability framework.</p>	<p>Identify published ESG commitments and metrics along with an assessment of controls, policies, procedures and data to support external ESG reporting.</p> <ul style="list-style-type: none"> • Assess ESG commitments and metrics against peers and regulatory expectations. • Assess entity level and ESG reporting processes and controls. • Assess IT controls over data governance, integrity and general control environment for supporting technologies. • Assess whether policies, procedures and controls ensure complete and accurate reporting of key metrics, including regulatory reporting considerations over metrics such as climate greenhouse gas emissions and cybersecurity. <p>KPMG accelerator: Metric risk assessment methodology and risk accelerator toolkit for a set of commonly reported metrics, informed by global regulatory reporting environment, including process flows, RACIs, and risk and control matrices.</p>	<p>Develop and design tactical steps for implementation of an internal assurance model over ESG reporting and setting course to embed ESG into the internal audit function.</p> <ul style="list-style-type: none"> • Support preliminary ESG risk assessment to help determine areas of focus. • Assist internal audit functions in embedding ESG considerations into their audit universe and plans and connecting the plan to strategic risks. • Support reporting strategy, policies, processes, controls, people, technology, data, etc. to achieve overall readiness. <p>KPMG accelerator: ESG operational risk templates, such as audit programs, risk assessments and audit reports.</p>



ESG governance assessment	Internal controls over sustainability reporting	ESG in internal audit
Market drivers		
<p>Global regulatory bodies are focused on increasing transparency on areas such as:</p> <ul style="list-style-type: none"> • How companies oversee governance of ESG risks. • How ESG-related risks are identified. • How they materially impact business strategies, models and outlook. <p>If adopted as proposed, these qualitative elements can have far-reaching impacts in formalizing how they govern, monitor, measure, analyze and report ESG activities, with internal audit having a key role in an effective governance and risk management structure.</p>	<p>Many companies voluntarily assess and report on their ESG commitments. A primary concern, however, has been the resulting lack of standardization across definitions, data and established controls to support these commitments.</p> <p>The inaugural standards issued by the International Sustainability Board (ISSB) is a milestone in providing a comprehensive global baseline of sustainability-related disclosures in response to the widespread demand for consistency and comparability in ESG data reporting.</p> <p>In addition, mandatory financial and non-financial ESG metric disclosures by jurisdictional regulators such as the European Commission’s CSRD and the US SEC climate proposed rules is indicative of the, increasing regulatory scrutiny, and emphasizes the need for a robust control environment to support the accuracy of disclosures.</p>	<p>In addition to the evolving regulatory environment, there is increasing focus and reliance upon company’s ESG reporting by a broad set of stakeholders from investors and consumers to employees, with stakeholders increasingly expecting ESG disclosures to be more transparent and 'investor grade' i.e. based on complete, accurate and comparable data, increasing the reputational risk associated with getting it wrong.</p>

Multidisciplinary approach

KPMG professionals have access to a wide range of ESG competencies, assets and solutions. This broad ESG lens requires a multidisciplinary team. KPMG has a 'one-stop-shop' approach to help ensure that the right professionals are engaged to support every client.

Experience

Our team of subject-matter professionals, with expertise in internal audit and ESG, has the skills and knowledge to provide internal audit services that can meet varied needs across a wide range of industries.



Contacts

John-Paul Font

Global Internal Audit Leader and Principal
KPMG in the US
jpfont@kpmg.com

Nadine Hönighaus

Global ESG Governance Lead and Partner
KPMG in Germany
nhoenighaus@kpmg.com

Steven Estes

US Internal Audit ESG Lead and Partner
KPMG in the US
sestes@kpmg.com

Adrian King

Partner in Charge,
Climate Change & Sustainability
KPMG Australia
avking@kpmg.com.au

Special thanks to Aila Pallera, Debbie Biddle-Castillo, Ivor O'Neill, Rachel Horne and Justin Kitts for their supporting contributions.

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2023 Copyright owned by one or more of the KPMG International entities. KPMG International entities provide no services to clients. All rights reserved.

KPMG refers to the global organization or to one or more of the member firms of KPMG International Limited ("KPMG International"), each of which is a separate legal entity. KPMG International Limited is a private English company limited by guarantee and does not provide services to clients. For more detail about our structure please visit kpmg.com/governance.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

Throughout this document, "we", "KPMG", "us" and "our" refers to the global organization or to one or more of the member firms of KPMG International Limited ("KPMG International"), each of which is a separate legal entity.

Designed by Evalueserve.

Publication name: Internal audit's role in ESG | Publication number: 138961-G | Publication date: August 2023